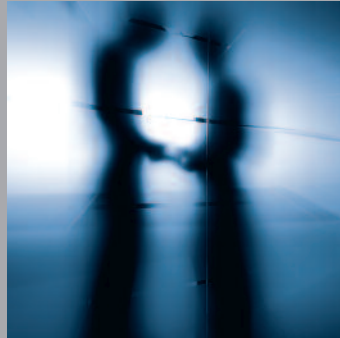


# reco<sup>®</sup> Report

F&C Investments

3rd Quarter 2006



## In this issue...

- Chasing the Green Pound:  
**Tesco** and **Wal-Mart** up the ante
- Land of the rising... shareholder:  
F&C tackles poison pills, pay and related-party transactions at 250 Japanese companies
- Masters of secrecy: How 16 banks are – or aren't – boosting transparency
- Best-practice ESG reporting:  
The F&C how-to guide in 12 easy steps
- FIFA fever and the fickle sporting goods customer
- Pipelines and ports, food and tobacco, banking and cement: How biodiversity hits the bottom line
- School buses, refineries and pipelines:  
Workplace headaches at **FirstGroup** and **BP**

**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](http://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](mailto:eve.crush@fandc.com)

**Or send to:** Eve Crush, Governance & Socially Responsible Investment, F&C Asset Management plc, Exchange House, Primrose Street, London EC2A 2NY

reo® is operated on behalf of:



# Introduction

The hot summer months saw ever more attention focused on the warming climate, as British supermarkets vied with one another for the ‘green pound’ and sought to persuade customers of their concern for cutting energy use, carbon emissions and waste, while protecting fish stocks and farm workers. Meanwhile, as football fever spread worldwide, sporting goods manufacturers were reminded of the fragility of global brands in the face of relentless scrutiny of their suppliers’ working practices.

Looking East, F&C wrote to over 250 of the 500 Japanese stocks it had voted to press for improvements ranging from shaking up boards, to tightening up pay, to ending poison pills. After three years of sustained effort, it is finally starting to show results. The US likewise saw plenty of action, with dialogue on remuneration, reporting quality, employee relations, biodiversity and more.

Finally, in this issue, we also turn our attention to the banking sector, focusing in particular on the strides many of the leading institutions have made to address the impact of their lending activities on the environment and local communities – and the gap that has grown ever larger between the leaders and the laggards.

## They said...

**“As these issues have become more mainstream, those supermarkets for whom this has been less of an issue have woken up to the fact that their customers are demanding it. If they don’t respond, there’s an opportunity for those who have been doing this for a long time to steal their customers.”**

Justin King, Chief Executive, J Sainsbury, “The GREEN Grocers – Why Britain’s supermarkets are falling over themselves to prove their environmental credentials”, *The Sunday Times (Business)*, 24 September 2006



**Karina Litvack** – Director, Head of Governance & Socially Responsible Investment, F&C Asset Management plc

## Engagement programmes

### Governance



Corporate Governance & Voting **6-7**

Transparency & Performance: Focus on Disclosure and Sustainability Reporting **8-9**

### Environment



Biodiversity and Environmental Management **10-11**

### Social



Focus on Labour Standards **12-13**

### Sector focus



Supermarkets **14-15**

# Companies featured in this report

## Corporate Governance & Voting

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Advantest	JP	Furukawa Electric	JP	Mitsubishi Electric	JP	Sumitomo Realty	JP
Astellas Pharma	JP	Glory Ltd	JP	Nippon Electric Glass	JP	Suzuki Motor	JP
Bank Tokyo-Mitsubishi	JP	Godo Steel	JP	Nishimatsu Construction	JP	Tokuyama	JP
Benesse Corp	JP	Hitachi	JP	Okumura Corp	JP	Toshiba	JP
Central Glass	JP	JFE Holdings	JP	Sharp	JP	Tosho Corporation	JP
Dai Nippon Printing	JP	Komatsu	JP	Shiseido	JP	Yamaha	JP
Daiwa Securities	JP	Marusan Securities	JP	Sieyu	JP	Zenrin	JP
Dowa Mining	JP	Mazda	JP	Sumitomo Corporation	JP	Zeon	JP
Fuji Photo Film	JP	Mitsubishi Corporation	JP	Sumitomo Metal	JP		

## Transparency and Performance

pages 8-9

Company	Countries	Company	Countries	Company	Countries	Company	Countries
ABN-Amro	NL	Charter	UK	ING	NL	Standard Chartered	UK
Aegis	UK	Citigroup	US	JPMorgan Chase	US	Verizon	US
Alliance & Leicester	UK	Commerzbank	DE	Kroger	US	Wachovia	US
Barclays	UK	Goldman Sachs	US	Lloyds TSB	UK	Wendy's	US
BBVA	ES	Group4 Securicor	UK	Pendragon	UK		
BNP Paribas	FR	Home Depot	US	Prodesse	UK		
Cairn Energy	UK	HSBC	UK	Rabobank	NL		

## Environment Biodiversity and Environmental Management

pages 10-11

Company	Countries	Company	Countries	Company	Countries	Company	Countries
AngloGold Ashanti	ZA	ExxonMobil	US	Lafarge	FR	Total	FR
BAT	UK	Forth Ports	UK	Mitsubishi Corporation	JP	Unilever	UK
Boots	UK	Freeport-McMoRan	US	PPB Oil Palms	MY	Wm Morrison	UK
BP	UK	HSBC	UK	Rio Tinto	UK	Woodside	AUS
Cadbury Schweppes	UK	Illinois Tool Works	US	Royal Dutch Shell	NL/UK	Xstrata	UK
Chevron	US	IOI Corp	MY	Sainsbury's	UK		

## Social Labour Standards

pages 12-13

Company	Countries	Company	Countries	Company	Countries	Company	Countries
adidas Group	DE	Costco	US	JJB Sports	UK	Puma	IT
Altria	US	Dell	US	KarstadtQuelle	DE	Time Warner	US
Bed Bath & Beyond	US	FirstGroup	UK	Kimberly-Clark	US	Umbro	UK
BP	UK	Hasbro	US	Mattel	US	Walt Disney	US
Coopers Industries	US	IBM	US	Nike	US	Yue Yuen Industrial	CN

## Sector focus Supermarkets

pages 14-15

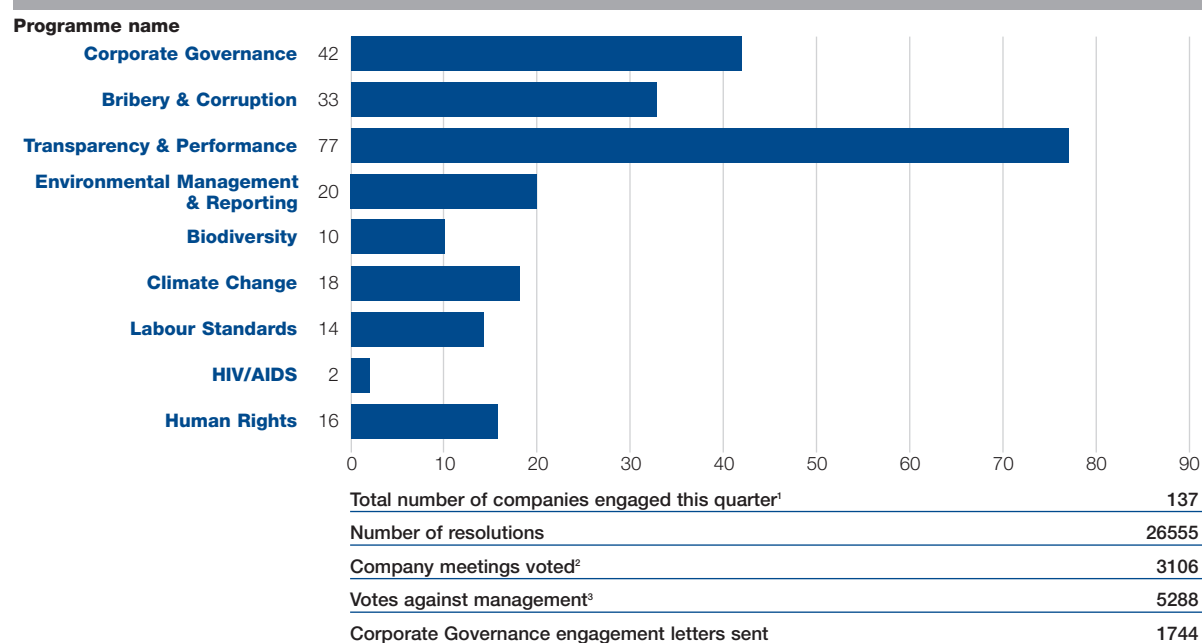
Company	Countries	Company	Countries	Company	Countries	Company	Countries
Carrefour	FR	J Sainsbury	UK	Tesco	UK	Wal-Mart	US
Co-op	UK	Marks & Spencer	UK	Waitrose	UK	Wm Morrison	UK

# Activity report

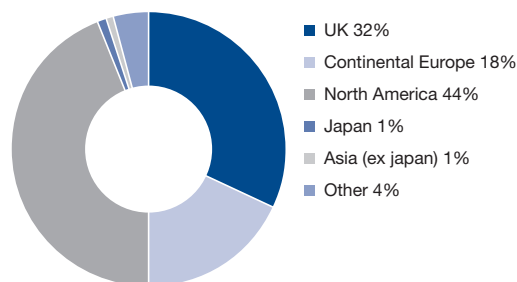
F&C's responsible engagement overlay is unique in the depth and breadth of its engagement, as the quarterly statistics below demonstrate. Key features are:

- 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

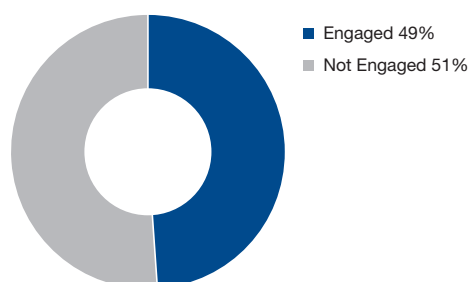


## Geographical spread



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

## Engagement of FTSE-350 companies<sup>4</sup>



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

1 Companies may have been engaged on more than one issue  
 2 i.e. company meetings for which F&C has issued voting instructions  
 3 Votes against management or abstentions  
 4 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	3106	-
Number of countries in which we voted	54	-
Number of resolutions	26555	100
Total votes for management	21267	74.7
Votes against management	1719	6.1
Abstentions	3569	12.5
No vote	1906	6.7

### Analysis of votes

Issue	% for	% against	% abstain	% split	% no vote
Routine business	79	4	7	0	10
Directors	76	2	18	0	4
Capital	77	10	2	0	11
Mergers/reorg	90	1	4	0	5
Share options etc	64	12	15	0	8
Anti take-over	50	50	0	0	0
Others	76	7	10	0	7

### Shareholder resolutions number of votes for or against management

	for	against	abstain
	113	343	106

### Engagement by F&C

#### Japan: "A Vote with a Voice™"

In Japan, as in all global markets, F&C combines active voting with detailed dialogue with its companies – both before the vote when writing to advise of its governance policies, and afterwards, to explain votes against management. This unique approach enables better information, more pragmatic voting and in-depth one-to-one discussions.

In early 2006, F&C mailed its Japanese corporate governance guidelines to 500 Japanese companies, highlighting its key concerns over board effectiveness and shareholder rights. While we welcome some of the changes

introduced under the 2005 Company Law, such as new requirements for disclosure on director independence, we strongly oppose provisions allowing boards to act without prior consultation of shareholders.

After casting our votes, we followed up with over 250 letters, either explaining the reasons for any votes against management or highlighting on-going concerns. While much more remains to be done, "A Vote with a Voice™" is beginning to bear fruit, with moves to reduce board size (e.g. **Nishimatsu Construction**), to put executive remuneration to a shareholder vote (e.g. **Sumitomo Corporation**), and to have a majority independent board of statutory auditors (e.g. **Suzuki Motor**).

F&C also responded to the Tokyo Stock Exchange's consultation on the *Discussion Paper on Improvements to the Listing System*. We welcomed the emphasis on enhanced transparency of corporate reporting. However, we also called for companies to disclose all material related-party transactions. We asked that they disclose any shareholdings that controlling shareholders may have in other companies or investment vehicles that have a material interest in the company. And finally, we recommended that companies have provisions for respecting minority shareholder rights.

### A sea-change in company articles...

2006 saw a wave of requests to change company articles to give boards the freedom to set dividend payments or repurchase shares without prior shareholder approval. We voted against all such resolutions, for example at **Benesse Corp, Bank Tokyo-Mitsubishi, Daiwa Securities Group Inc, Hitachi Information Systems, and Mitsubishi Electric**, on the grounds that an annual vote on these requests is an important line of accountability between companies and their owners.

### ...with poison pills creating waves

In 2006, anti-takeover defences (a.k.a. poison pills) remained a hot topic following new 2005 Company Law provisions that allow certain anti-takeover devices without prior shareholder consultation. This flew in the face of calls from international investors, including F&C, to eschew poison pills and to establish an anti-takeover code instead. F&C voted against directors at **Central Glass, Dowa Mining, Sharp, Yamaha** and **Zenrin** to register its concern about the board's approval of anti-takeover measures without prior shareholder consent. We also voted against anti-takeover defences and related changes to Articles at **Shiseido, Sumitomo Metal Industries, Sumitomo Realty & Development Company, Tokuyama, Tocho Corp** and **Zeon**, on the grounds that the best defence against takeovers is good management. By contrast, we backed management's anti-takeover defences at **Marusan Securities** and **Nippon Electric Glass**, because the companies sought general shareholder approval and the devices were of limited duration, and recommended the companies lobby for the development of an anti-takeover Code to make such defences obsolete.

### F&C tightens up on board effectiveness...

Japanese company boards are often very large, with up to 55 directors and few, if any, independent members, which raises real questions about their effectiveness. F&C signalled its concern by voting against at least one board member at such companies, including **Fuji Photo Film, Glory Ltd** and **Godou Steel**. Meanwhile, F&C continues to encourage companies to create dedicated board committees as the best way to ensure effective and accountable decision-making. This follows amendments to Japanese Company Law in 2003 allowing adoption of a "three-committee structure". While some 36 companies made the leap immediately (e.g. **Hitachi, Sieyu, Toshiba**), others have dragged their feet.

### ...while calling for auditor independence

With the corporate landscape still dominated by the traditional board of statutory auditors, Japan has yet to embrace fully the principles of auditor independence and board responsibility for the auditing process. Unless companies adopt the three-committee structure, non-independent auditors employed by the company may take their seat on the statutory auditor board without any formal oversight by the company board.

F&C goes further than Japanese Company Law by calling, at a minimum, for the majority rather than half of statutory auditor board members to be independent. Our record at the ballot box reflected our firm line, with abstentions on all candidates whose appointment would have made the statutory auditor board majority non-independent. We also voted against amendments seeking to reduce auditor liability, for example at **Advantest, Astellas Pharma, Dai Nippon Printing, Fuji Photo Film, JFE Holdings, Mazda Motor Corp**, and **Mitsubishi Corporation**, on the grounds that audit quality and oversight are still weak in this market.

### ...and supporting changing incentives

Continuing a nascent trend of 2005, more Japanese companies have opted to abolish retirement bonuses (e.g. **Furukawa Electric**). We generally supported these moves as a welcome shift towards 21st century reward systems, except where the amount of compensatory payments was not disclosed or payments were made to non-executives (e.g. **Okumura Corp**). We also supported new stock option plans (e.g. **Komatsu**) and recommended they be tied to performance conditions.





## Focus on Disclosure and Sustainability Reporting

### Our objectives

- Encourage adherence to F&C Corporate Social Responsibility Governance (CSRG) policies with a focus on:
  - Board responsibility and effective structures to exercise this responsibility
  - Formal policies on all significant CSR issues
  - Management and monitoring systems for implementation of CSR policies
  - Public reporting and disclosure.

### Engagement by F&C

#### What does F&C expect?

F&C expects high standards of transparency from the companies in which it invests. This should include a narrative account within the annual report about the trends and factors affecting the performance and future development of the business. So-called '**narrative reporting**' is an important mechanism for improving the quality of dialogue between companies and their owners, covering the full range of factors underpinning long-term profitability. This includes areas that have not been traditionally covered in annual reports such as material **environmental, social and governance (ESG)** issues. In high-impact sectors, we also expect companies to publish a comprehensive sustainability or corporate social responsibility report that provides more detailed information for a wider group of stakeholders such as local communities, non-profit organisations, and government representatives. While we recognise that ESG reporting will vary across geography and sector, we have identified some general best practice guidelines, set out below.

#### F&C's 12 steps to best practice ESG reporting

##### Basic

- Establish and explain board accountability for ESG issues
- Identify significant ESG risks and opportunities for the business
- Set out policies for significant ESG issues and explain how they are implemented and monitored
- Disclose key ESG targets and Key Performance Indicators covering global operations
- Describe systems for training board members and staff on ESG issues
- Report on performance against policies

##### Best practice

- Explain how ESG policies link to key operational and financial drivers

- Describe procedures for consulting key stakeholders and provide feedback on the range of views
- Discuss challenges and set-backs as well as success stories
- Describe procedures for verifying data including external verification
- Take account of widely-accepted reporting standards such as the Global Reporting Initiative
- Describe how ESG objectives are embedded into the corporate culture, including how they are reflected in remuneration policies and other performance management tools

#### F&C engages regulators to enhance quality

As various countries update their accounting standards, F&C called on the International Accounting Standards Board (IASB) to establish a high standard for narrative reporting, with the publication of best practice guidelines. This is important, not only to ensure improvements globally, but to create a level playing field across markets.

Meanwhile, closer to home, F&C called on the UK government to take steps to boost the quality of reporting within the 'Business Review', following its surprise scrapping of the Operating and Financial Review (OFR) in late 2005. This is particularly important given the introduction of far-reaching 'safe harbour provisions' for directors, addressing concerns about personal liability for forward-looking statements. While F&C believes safe harbour provisions are important to avoid meaningless 'boiler plate' reporting, these must be accompanied by a step change in the quality of disclosures.

#### Voting with our feet

In 2005, F&C had abstained or voted against the reports and accounts of over 10 UK companies, including **Cairn Energy**, **Group4 Securicor** and **Pendragon** due to inadequate reporting on ESG issues. In 2006, we rewarded improvements with positive votes, including at **Cairn** and **Pendragon**, while abstaining at **Aegis Group** and **Charter PLC**, amongst others, for poor disclosure. We

also abstained at **Prodesse**, which failed to disclose fees paid to non-executives or put its remuneration policy to a shareholder vote. In the US, we continued to support resolutions calling for annual sustainability reporting at fast food company **Wendy's** and at supermarket chain **Kroger**. We also called for enhanced reporting on political donations and equal opportunities in the workplace, for example at **Verizon** and **Home Depot** respectively.

## We said...

**“The Government should create strong incentives for best practice narrative reporting based on the framework set out in the Accounting Standards Board’s Reporting Statement... Under this non-prescriptive approach, it will be for investors to then evaluate whether this level of disclosure is adequate for their purposes and the onus will be on companies to explain any omissions, including on any significant governance, social and environmental issues.”**

Extract of letter from F&C to UK Government, 23 March 2006

## Focus on...

### Transparency in the Banking Sector

#### Key issues and concerns

Like any company with a large workforce and operations that span the globe, banks have significant “direct” impacts on the environment and on society. Yet these are modest when compared to their “indirect” impacts, which arise through the funding of client activities, and can heighten default risk as well as damage hard-won reputations that rely on prudence and trust. Banks have traditionally faced contradictory “pushes” and “pulls” in terms of transparent disclosure and reporting of their activities, with strict compliance requirements and client confidentiality restricting some information flows. Yet F&C has long encouraged increased transparency on the basis that shareholders need to know about any ESG issues that might affect the bottom line and relationships with key stakeholders.

#### F&C acts ... lifting the lid on lending

Since 2002, F&C has called for greater openness, particularly calling on banks to report on how they integrate environmental and social risk issues into their lending decisions. While companies have made varying degrees of progress, there is now consensus among the leading banks that it is no longer sufficient only to report on internal environmental performance. This has been reflected in the high number of Corporate Responsibility reports that have sections on “Responsible Banking/Lending” or “Marketplace” as well as “Environmental Impacts” or “Protecting our Environment”. Following the publication of a pioneering

F&C benchmarking study “*Environmental Credit Risk in the Pan-European Banking Sector*” in 2002, a number of banks, including **ABN Amro, Barclays, Citigroup, Goldman Sachs, HSBC, ING, JPMorgan Chase, Standard Chartered** and **Wachovia** have also published environmental policies and guidelines for lending to high-impact sectors.

- Progress has been slower on social issues, as highlighted in F&C’s joint research study with KPMG entitled “*Banking on Human Rights*”. However, there has been some movement with **Alliance & Leicester, Barclays, HSBC, ING, Lloyds TSB, Rabobank** and **Standard Chartered** all publishing human rights policies over the last couple of years. **ABN Amro** stands out as leading the way by providing details on how it factors human rights issues, corruption, and political and military stability into its Country Social and Ethical Risk Framework (CSERF), which informs its country and project risk analysis.
- F&C has also pushed for enhanced reporting on the implementation of Equator Principles (EP) for project finance. Developed in 2003 with participation from F&C, the EP integrate the social and environmental compliance standards of the World Bank Group into the loan covenants of project finance deals, such as pipelines and dams. F&C has engaged with over 25 banks to improve training, risk assessment techniques and performance monitoring and reporting. In 2006, **ABN Amro, Barclays, Citigroup** and **HSBC** all provided enhanced disclosure on EP implementation with details of the number and value of transactions where the EP were applied, and the specific steps being taken to ensure compliance with the nine core Principles.

#### Next steps ... spreading the word

While ESG disclosure has improved significantly, progress is uneven with some banks, such as **Commerzbank, BBVA** and **BNP Paribas** still reporting exclusively on direct impacts. Banks in other parts of Europe, such as Greece, are becoming increasingly attractive growth opportunities, yet have extremely limited management and reporting of ESG issues. F&C will continue to press for the adoption of global best practice in these and other less developed markets, while also encouraging all banks to explain how the management of ESG activities can help the bottom line, either by contributing to writing higher-margin business, improving competitive advantage, deepening client relationships, enhancing reputations or engaging employees.





## Focus on Environment

### Our objectives

- Biodiversity: encourage all companies where biodiversity is a material risk to adopt a policy and management process for their direct and indirect biodiversity impacts
- Environmental Management & Reporting: ensure that companies introduce robust systems to identify environmental risks, develop effective Environmental Management Systems, disclose performance and formulate an appropriate strategy.

### Biodiversity

#### Background: the importance of ecosystem services

The UN-sponsored *Millennium Ecosystem Assessment*, which included F&C's contribution on 'Business and Biodiversity', emphasised the role of 'ecosystem services' in fostering productive economies, i.e. the social and economic value-added provided by the various functions of the natural ecosystem. Examples of these include the provision of clean water supplies, food and building materials.

Many companies are dependent on biodiversity or ecosystem services, and so are potentially vulnerable to the mismanagement of biodiversity by others. Other companies can play a key role in either enhancing or damaging the biodiversity that underpins such services, but are often unaware of this. Those that have negative impacts can receive an unpleasant wake-up call from regulators, or targeted and well-informed campaigns on issues such as sustainable fishing and tropical timber. However, companies also have the ability to enhance biodiversity, both by driving higher standards through their supply chains and by good land management practices.

F&C's research suggests that companies often lack a strategic approach and find it difficult to integrate biodiversity issues into their standard environmental management systems – resulting in late action or neglect of important environmental factors. However, biodiversity-related issues such as access to land, relations with regulators and stability of supplies from natural products may have a direct impact on a company's performance.

#### Engagement by F&C

F&C's 2004 research report, '*Is biodiversity a material risk for companies?*', had highlighted nine high-impact sectors on which we focus our engagement. The complexity of biodiversity management, even for conservation professionals, means that there is no standard approach to corporate management. However, we have identified three trends that are emerging in the way that companies approach biodiversity management, and have been actively endorsing and promoting these techniques:

#### Independent panels

Several companies have appointed independent or external panels to oversee specific projects: the first examples were **BP's** Tangguh gas project in Indonesia and Baku-Tbilisi-Ceyhan pipeline in Central Asia, and the **Royal Dutch Shell** Sakhalin II offshore gas project in Russia. More recently, panels have been set up by **Woodside Petroleum** in Mauritania, **Xstrata** at Las Bambas in Peru, and **Forth Ports** in Scotland, to oversee its proposed ship-to-ship transfer project in the Firth of Forth. Although these panels at times consider a range of issues besides biodiversity, they can help companies address stakeholder concerns and overcome accusations of bias. F&C participates in panel consultations, and has strongly advocated the creation of credible panels for new projects, including those cited above. We stress that key features of such panels are: independent membership, credible experts, openness to stakeholder input, public reporting and, critically, being commissioned early in the project development process.

#### Partnerships with expert bodies

In addition to addressing biodiversity issues on a project-by-project basis, some companies have set up strategic panels or partnerships with specialist NGOs to provide oversight of the company's approach and activities. Examples of this are **British American Tobacco**, **ExxonMobil**, **Rio Tinto**, **Lafarge** and **HSBC**. F&C has been supportive of this approach, but has pressed companies to report openly about such relationships and the tangible results that accrue from them. There is a danger that unless such partnerships are transparent and results-orientated, companies will be subject to accusations of "buying off" their critics. The **British American Tobacco** biodiversity partnership with four leading conservation NGOs, after a slow start, is emerging as a good model. As a major buyer of tobacco from over 250,000 farmers in developing countries, **BAT** faces the twin biodiversity challenges in its supply chain of sustainable agriculture and the production of wood-fuel, which is used for drying the tobacco. The partner NGOs are working with the company to identify negative biodiversity impacts and put in place farming and wood production methods that are biodiversity-friendly.

## Industry Collaborations

One major obstacle to protecting biodiversity is that, often, no single company, however large, can single-handedly change the way things are done: this is especially true with agricultural and commodities trading practices. Collaborating both with competitors and suppliers to produce an agreed minimum standard is therefore an increasingly common option. To encourage this, F&C has pressed a number of retail, producing, food and cosmetic companies to join the Round Table on Sustainable Palm Oil (RSPO). Recent signatories include **Wm Morrison, Tesco** and **Sainsbury's**, who join the 128 members including **Boots, Cadbury Schweppes, Unilever** and local producers **IOI Corp** and **PPB Oil Palms**. The RSPO aims to promote sustainable sourcing of palm oil through practical schemes such as certification, and has developed eight best-practice principles. An unexpected development in palm oil supply scenarios is the emergence of bio-diesel producers as potentially major users. F&C has started to encourage energy and heavy industrial companies to join the RSPO, such as **BP** and **Mitsubishi Corporation**, in order to ensure that any strategic decisions they take related to alternative energy supply adequately consider the biodiversity impacts of oil palm cultivation.

## Environmental Management and Reporting

### What gets measured gets managed...

In 2005, US manufacturing company **Illinois Tool Works (ITW)** earned an unenviable spot on the US Environmental Protection Agency's Toxic Release Inventory's list of 'Top 100 Emitters' of specific pollutants. However, with an entirely corporate client base for its fasteners, industrial fluids, machinery and other products, **ITW** was insulated from potential consumer backlash. F&C was concerned that without a clear view of the company's approach to managing environmental risk, it lacked a proper understanding of the quality of its management and internal controls.

F&C attempted to initiate a discussion, but its calls for greater disclosure on the company's environmental management practices went unanswered. After a year with no progress, F&C filed a shareholder proposal in November 2005 inviting **ITW's** investors to support greater environmental disclosure by way of an annual sustainability report.

The filing prompted the company immediately to request dialogue with investors. It agreed to issue an interim sustainability report by mid-2006 and a full report by the 2007 annual meeting. In addition, the resulting dialogue identified several gaps in **ITW's** existing Environmental Management Systems, such as the lack of group-wide energy and emissions data, and provided the opportunity to share good practice from other companies and discuss investors' expectations for comprehensive reporting.

**ITW** ultimately agreed to a more formal process of

## The extractive sector – the best and the worst

Access to oil reserves or mineral rights is vitally important for extractive companies, yet is hampered when resources are located in or near protected or ecologically-sensitive areas. F&C considers that companies with a better track record in biodiversity management are likely to gain greater or faster access to reserves and suffer fewer delays in project development. Extractive companies' practices run the gamut from thoughtful and innovative to very poor – with weaknesses particularly among smaller companies and those from emerging markets such as China. F&C has an on-going programme of engaging extractive companies, based on the analysis in our 2004 report *'Are Extractive Companies Compatible with Biodiversity?'* In addition to long-standing dialogue with **BP, Royal Dutch Shell, Total, ExxonMobil** and **Chevron** recent engagement includes:

- **Rio Tinto**: better disclosure on its operations in Madagascar;
- **Freeport-McMoRan**: improvements in integrating biodiversity into environmental management systems and reporting;
- **AngloGold Ashanti**: disclosure of biodiversity KPIs and reporting against them.

### We said...

“We are increasingly concerned that **Illinois Tool Works is falling behind its peers in the industrial manufacturing sector where public disclosure is standard practice.... We believe ITW's lack of disclosure undermines the company's positive efforts in producing environmentally friendly products and addressing health and safety.**”

F&C letter to Illinois Tool Works, 16 November 2005

### They said...

“The collection and analysis of this data will be used to help develop projects and programs to improve environmental performance, further protect our employees and continue to reduce overall costs.”

Illinois Tool Works Interim Report on Corporate Citizenship, June 2006

environmental performance measurement and reporting, which it acknowledged enabled it to identify areas for enhanced efficiencies and risk reduction. As a result, F&C withdrew its shareholder proposal, and instead provided detailed feedback on the forthcoming sustainability report.



## Focus on Labour Standards

### Our objectives

- Encourage companies to adopt a code of conduct on labour standards (based on ILO Core Conventions), and to develop a management system to implement the code, audit compliance and work with suppliers to address weaknesses
- Encourage companies to adopt higher workplace standards and management systems relating to non-discrimination, work-life balance, glass ceilings and diversity management.

### Engagement by F&C

#### Introduction

Companies today face a challenge: they must be competitive, which involves producing at the lowest possible cost. Yet this implies operating in regions where employment practices may not meet internationally-recognised standards for safety and fairness, thereby raising potential reputational risks related to public concerns about 'sweatshop labour'. F&C considers that certain companies, particularly those with strong consumer brands in countries with media-savvy pressure groups, face significant business risks, and therefore need to demonstrate that they have sound practices to deal with them.

#### What is at stake?

**Customer needs:** To meet commercial objectives, companies in developed and emerging markets depend on good employee relations - both in their own workforce and their supply chain. Industrial disputes, poor productivity or labour shortages may result in business disruption, while a productive workforce can be relied on to meet customer orders, helping to win repeat and new business with customers.

**Reputation:** allegations of shoddy practices, litigation or significant prosecutions may put at risk a company's ability to recruit the best talent and win access to key markets. Conversely, a reputation for good employment practices secures a loyal and productive workforce and re-enforces public trust, protecting a company's brand and relationships with consumers and regulators.

#### What does F&C look for?

F&C has pressed companies to improve labour standards in both their workforce and supply chains, by focusing on:

- **Implementation of international codes of conduct:** for good labour standards to be a part of everyday working practice, F&C expects companies to assess risks related to labour standards, adopt appropriate codes and monitor how effectively these are implemented, and take effective action to turn around poor practice.
- **Boosting Health and Safety** management systems and performance.

- **Improving reporting** on their supply chain practices, including warts-and-all progress reports on supplier performance and the challenges ahead.

#### F&C acts – Promoting global good practice...

F&C considers that in order to meet global standards of good practice, companies should adopt a code of conduct based on the ILO Core Conventions, which cover basic employment standards for workers. In the last year, F&C has assessed the labour standards practices of 200 companies prior to investing in them; in cases where companies were identified as high risk, we have recommended adoption of a labour standards code based on the ILO Core Conventions.

In the USA, labour standards concerns are often raised with management through shareholder resolutions at Annual General Meetings. F&C has identified the following companies as high risk and supported shareholder resolutions calling on them to commit publicly to the ILO Core Conventions: **Altria Group, Bed Bath & Beyond Inc, Coopers Industries Ltd, Costco Wholesale Corporation, Dell Inc, Hasbro, International Business Machines, Kimberly-Clark, Mattel, Time Warner** and the **Walt Disney Company**.

Although many companies have adopted codes based on the ILO Core Conventions, some have faced criticism for failing to meet the Conventions' challenging standards, such as protection of trade union rights. Following allegations of overly aggressive anti-union practices by UK transport operator **FirstGroup** in its US operations, F&C held meetings with the Chief Executive, the Chairman, and a separate meeting with US trade union representatives. These meetings suggested that the company's management of labour standards fell short of best practice and represented a potential risk to the company's overall business performance.

In particular, we noted that a reputation for poor employment practices could jeopardise **FirstGroup's** contracts with public authorities. We recommended that **FirstGroup** tighten group-wide controls by communicating to employees a policy explicitly referring to trade union rights, training US management staff on best practices and transparently reporting on implementation of the policy.

After continued pressure from F&C and fellow investors, **FirstGroup's** Chief Executive announced a review of company policies to reflect best practice. He reassured investors that contracts with customers were not at risk, announced a new training programme for US staff and committed to reporting on performance against policies in future. As a result of the company's cooperation on this matter, F&C abstained on a shareholder resolution calling for adoption of the ILO Core Conventions.

### More headaches at BP

Health and safety performance is so fundamental for some companies that it serves as an important indicator of management quality. This is especially true for companies operating in inherently high-risk sectors or regions, and for those with far-flung operations where discrepancies may arise between "Head Office" policies and actual implementation in distant locations.

**BP** is one company that has a good track record in health and safety, but the devastating explosion at its Texas City refinery in March 2005, which caused 15 fatalities and an unconfirmed number of injuries, revealed serious deficiencies in its operations at that site. The reports into the explosion identified five underlying causes and made 81 recommendations for improvement. Coming on top of earlier health and safety incidents in the company's Alaskan operations, this raised concerns about the potential for similar problems elsewhere in the North American operations; these have now been reinforced by the recent shutdown of half the company's production capacity at its Prudhoe Bay field in Alaska following the discovery of extensive corrosion in the pipelines.

F&C has been in dialogue since 2002 with the company over several related issues: the ability of the company to implement global policies at local level; the effectiveness of its whistleblowing systems; the scale and timeliness of maintenance; the extent to which performance incentives may favour maximising production at the expense of following operating procedures; and whether the recurrence of problems at the North American operations indicates systemic management problems associated with **BP's** spate of acquisitions in the past eight years. The recent Prudhoe Bay incident has cast further doubt on **BP's** leadership aspirations in the area of social and environmental

performance. F&C has historically considered **BP** to be among the strongest performers in this area, with particular strengths in subjects such as climate change, but these back-to-back failures have dented the company's credibility and called into question the ability of top management to deliver on its commitments.

### World cup fever... but a red card for sweatshops

With the 2006 FIFA World Cup™ generating unprecedented interest around the world, F&C recommended that the global sportswear giants sponsoring football teams safeguard their brands; we specifically recommended companies be especially vigilant in delivering on past promises to eliminate sweatshops in their supply chain.

The sportswear industry has made huge strides since accusations of child labour at the 1998 and 2002 World Cups, evident in the establishment of codes of conduct, independent monitoring of factories and warts-and-all reports by leading brands such as **Nike**. However, the industry still needs to convince consumers that it has cleaned up its act – and as the 2006 World Cup kicked off, yet another prominent campaign group accused companies of breaking their promises to workers.

While standards cannot improve overnight, F&C considers that transparent reporting about supply chain performance and the challenges that lie ahead is a good place to start. Ahead of the 2006 World Cup, F&C wrote to six companies, including Italian team sponsor **Puma**, FIFA partners **adidas Group** and **KarstadtQuelle**, as well as **JJB Sports**, **Umbro** and **Yue Yuen Industrial**.

F&C recommended that these companies identify their highest-risk suppliers; establish monitoring of their factories; provide a means for workers confidentially to report concerns; train factory personnel to improve in areas of weakness; and publicly report on policies and actual practice. Responses from **adidas Group**, **Puma**, **KarstadtQuelle** and **Yue Yuen Industrial** indicate significant progress is underway, while **JJB Sports** and **Umbro** have not yet responded.

### We said...

**“We welcome the company's focus on labour standards at Sialkot and more broadly, the leadership position that the adidas Group has taken to improve labour standards performance, particularly the establishment of new Key Performance Indicators to raise the bar among suppliers.”**

Extract of F&C letter to adidas Group Global Director, Social & Environmental Affairs, June 2006

### They said...

**“In short, our brand is visible all over the world. Current developments that further increase our visibility are the 2006 FIFA World Cup™ in Germany. This will draw even more attention to the adidas Group with millions of people watching the games... From a social compliance perspective, managing this increased visibility is a challenge, as we know from issues raised at previous World Cups.”**

adidas Group, *Connected by Football*, Social & Environmental Report 2005



## Focus on Supermarkets

### Our objectives

- Encourage companies to identify and manage environmental, social and governance (ESG) issues that may influence customer purchasing decisions or regulators
- Encourage companies to adopt higher standards in nutritional labelling, climate change, community consultation and supply chain management.

### They said...

“**The Battle to win customers in the 21st century will increasingly be fought not just on value, choice and convenience but on being good neighbours, being active in communities, seizing the environmental challenges, and on behaving responsibly, fairly and honestly in all our actions. It requires leadership, risk and innovation. We embrace this challenge.**”

Sir Terry Leahy, Chief Executive of Tesco, launch of Tesco's Community Plan, 10 May 2006

### They said...

“**Green issues are now about attracting and retaining customers rather than just about morals... successful companies stay slightly ahead of trends and this is now a very major trend and a great business opportunity.**”

David McCarthy, Managing Director, European Food Retail Team, Citigroup, Note to clients, 31st August 2006

### Engagement by F&C

#### Competition for the green pound heats up...

UK consumers have recently seen a flurry among the biggest supermarkets to win their “green pound” with a raft of new environmental initiatives:

- **Tesco** announced a new Community Plan committing £100 million to renewable energy and loyalty card points for re-using carrier bags.
- **Sainsbury** launched compostable packaging for its own-brand products.
- **Wal-Mart's Asda** pledged to stop sending waste to landfill within four years.
- **M&S** launched an advertising campaign encouraging customers to “*Look Behind the Label*” to find genuinely responsible business practice.

#### What lies behind the new battle for customers?

**The chink of cash tills...** Valuations of food retailers by investors are strongly based on sales growth prospects. In mature markets, consolidation means that a handful of

large supermarkets are competing for fickle customers; they need to find innovative ways to maintain customer loyalty and drive sales. While supermarkets such as Tesco have responded by moving into non-foods, such as DVDs, household goods and clothing, new commercial opportunities are also emerging through customer concern about health and environmental issues – as evidenced by the soaring growth in organic products, which rose by 30% in 2005<sup>5</sup>.

**The clamour for accountability...** Getting the green light to open new stores depends on whether or not supermarkets are seen to contribute positively to local economies. This is as true at home as in emerging markets, where the rise of foreign retailing giants often gets a mixed reception. Yet large supermarkets have been caught off-guard; their wider impact on society has been challenged by pressure groups, politicians and small shopkeepers.

**Wal-Mart's** bitter experience of local communities opposing new stores in the United States and Canada has prompted the company to establish a high-profile lobbying effort to burnish its reputation, and serves as a wake-up call for big supermarkets: ignore social and environmental risks at your peril.

#### F&C Acts

F&C has engaged with major international food retailers **Wal-Mart**, **Carrefour** and **Tesco** for over three years to highlight the link between environmental, social and governance risks to overall business performance.

In the UK market, the sector has been the subject of intense public criticism, culminating in the announcement of a regulatory review of the UK market, and prompting F&C to step up its dialogue with **Tesco**, **J Sainsbury**, **Wm Morrison Supermarkets** and **M&S**. We have encouraged these companies to:

- **Adopt a strategic approach to ESG issues:** we have recommended companies adopt a clear strategy that considers and responds to emerging issues that may influence customers. We have drawn attention recently to childhood obesity and nutritional labelling, climate change, protecting fish stocks and palm oil cultivation.

#### ■ Effectively manage ESG issues that may affect the political landscape:

we have pressed companies to identify which ESG issues may significantly impact their operating environment and encouraged them to be sensitive when engaging in the political process on such issues. We have highlighted the need for sensitivity, for example through good practice in consulting with local communities on plans to build new stores. We have also encouraged high standards in political donations and lobbying, which are increasingly scrutinised by the public.

#### ■ Establish robust internal controls for regulated ESG areas:

we have requested evidence of processes to comply with competition and employment regulation, noting the industry has come under regulatory scrutiny.

#### The sector responds by...

##### ...prioritising consumer concerns

■ The industry has done this in many places; for example **M&S** is selling Fairtrade cotton clothes and **Carrefour** has developed a nutrition strategy in response to rising obesity.

■ **M&S, Sainsbury** and **Tesco** strengthened their policies for sustainable sourcing of seafood, followed by **Wm Morrison**. In the USA, **Wal-Mart** pledged to buy all wild-caught seafood for North America from fisheries certified by the Marine Stewardship Council within the next three to five years.

■ **Tesco, J Sainsbury, Wm Morrison** and **M&S** joined the Roundtable on Sustainable Sourcing of Palm Oil, which aims to promote the use of sustainably-grown palm oil, rather than through clearance of tropical rainforests.

##### ...demonstrating greater political sensitivity

■ **Tesco** has faced the brunt of public criticism in the UK. The company recently announced it would focus more on community consultation and building strong relationships with NGOs. **Tesco** also agreed to review the aggregate sum of political donations requested for shareholder approval.

#### ...and tightening internal controls

■ **Tesco** has been given a clean bill of health by regulatory investigations, but has nevertheless taken the lead in improving internal controls for anti-competitive practices. The company has established a dedicated senior compliance manager for the UK Supermarkets Code of Practice governing supplier relations and strengthened mechanisms for suppliers to report concerns.

#### ■ **Tesco, J Sainsbury, M&S, Waitrose<sup>6</sup> and Wm Morrison**

have encouraged suppliers to act early in anticipation of the new Gangmasters Licensing Act requirements, aimed at promoting higher labour standards in agriculture and related industries.

#### The prodigal son: Tesco takes a leadership role

As the world's fifth-largest food retailer, **Tesco** has taken a significant step towards better practice: its CEO has publicly committed to corporate responsibility leadership and shown a clear action plan to achieve this. **Tesco's** public commitments mark a turning point for the global food retail industry - the "green war" that has erupted in the UK signals that change is afoot.

#### A challenge for the sector: Compete or cooperate?

Competition in the industry drives innovation, which benefits the customer, while also growing the bottom line for the leading companies. Competition has added value in areas such as organic food, where clear common standards are well established and growth has increased choice and reduced prices. However, the industry faces difficult challenges in areas where the scale of the problem is so great that no single company can succeed by acting alone. Such is the case, for example, with protecting fish stocks and tropical rainforests, which require costly and disruptive changes to global supply systems. The solution lies in supermarkets and manufacturers joining forces to support industry-wide efforts, where scale and market power can effect change. To date, there has been real progress in issues such as chemical safety, supply chain labour standards and more recently palm oil cultivation.

#### F&C outlook

F&C considers that to cash in on the green pound in the UK, the **Co-Op, Waitrose, M&S, J Sainsbury, Tesco, Asda** and **Wm Morrison** need to build the industry's green credentials through strong ESG practices and communication to customers about these. Development of common industry standards is likely to play an important role in achieving the changes that are needed, and protecting the sector from consumer and regulatory backlash.

#### We said...

“At the end of the day... the industry's reputation is only as good as its weakest player. If consumers face confusion when it comes to green shopping, there is a risk they will simply be turned off. So getting **Tesco, Sainsbury, Waitrose, Asda, Wm Morrison, the Co-op and Marks & Spencer** to agree certain basic standards could help their customers make better-informed decisions, create efficiencies and ward off red tape.”

Karina Litvack, Head of GSRI, F&C Asset Management, *The Sun*, 11 September 2006

“If you make empty promises you end up with mud on your face. This can't be just about greenwash. Consumers want green choices.”

Sue Dibb, National Consumer Council, *The Financial Times*, 14 September 2006

<sup>5</sup> UK organic food sales rose by 30% to £1.6 billion from 2004 to 2005 according to the Soil Association

<sup>6</sup> Although not a listed company, Waitrose is owned by the John Lewis Partnership, of which F&C Asset Management is a bondholder.

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#### **Important information. All data is as at 30 June 2006 unless otherwise stated.**

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