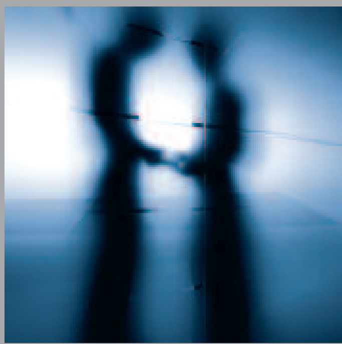
r(e)o® Report

F&C Investments | 4th Quarter 2006









In this issue...

- **Aegis** and **Prodesse** fight off raiders 'with a little help from their shareholder friends'
- UK ABI follows F&C's lead on clawbacks
- F&C leads $12 trillion investor coalition in backing transparency in extractives sector
- Post-Stern, F&C presses President Barroso for tough cuts in CO_2 emissions
- Biofuels bonanza: F&C urges caution in sourcing agricultural feedstocks
- The digital revolution and its discontents: Balancing free access with security and privacy
- **BAE Systems** in the hot seat: Why corruption investigations hurt investors

F&C Investments

Expect excellence

Our philosophy

reo® stands for responsible engagement overlay

The objective of ***reo***® is to use the influence that F&C has through the share ownership of its clients to encourage investee companies to enhance their business performance by adopting better corporate governance, social, and environmental practices. F&C believes that it can better serve its clients, and protect the value of their shareholdings, through sustained and constructive dialogue with companies as well as the judicious and transparent use of its votes, thereby ensuring that companies respond prudently to the emerging expectations of shareholders and other stakeholders.

Why this report?

Our obligations to you

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

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

What does this mean in practice?

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

In addition, where F&C is your fund manager, this means exercising our voting rights – **your** voting rights – at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world.

Transparency: It cuts both ways

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

What could we do better?

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

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

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

Feedback: Your money listens

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

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

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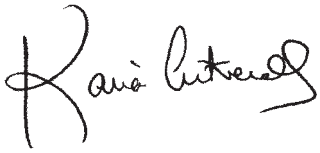
Introduction

The fourth quarter of 2006 was dominated by the UK Government's release of the *Stern Review on the Economics of Climate Change,* the first-ever comprehensive analysis of the costs of action and inaction on climate change. The repercussions for the financial markets are enormous, as the Review maps out the vast opportunities that lie in financing a global shift to a low-carbon energy system. Besides contributing to the Review, F&C pressed both Prime Minister Blair and European Commission President Barroso to enact clear and ambitious policies to enable companies and their investors to make large-scale investments in innovative technologies.

Still on the global stage, F&C led a $12 trillion coalition of over 70 investment institutions in support of the *Extractive Industries Transparency Initiative,* an international effort led by Prime Minister Blair to encourage resource-rich developing countries and the oil and mining companies to publish side-by-side audited figures of the payment flows associated with their extractive activities. Transparency on these multi-million payments can curb corruption and mismanagement and bring about a safer investment climate, benefiting local citizens, companies and their investors.

F&C also launched the first-ever study of how the Technology sector balances the conflicting demands of Access, Security and Privacy in the fast-changing, confusingly regulated world of the digital revolution. And closer to home, F&C waded into the debate on Audit Quality, Auditor Choice and the Business Review – successor to the ill-fated Operating and Financial Review, while welcoming the ABI's move to tighten up its stance on reclaiming executive bonuses paid on the basis of materially misstated accounts.

> "The transition to a low-emissions global economy will open up many new opportunities across a wide range of industries and services. Markets for low carbon energy products are likely to be worth at least $500 billion per year by 2050, and perhaps much more."
>
> ***Stern Review on the Economics of Climate Change,***
> **30 October 2006**



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

Engagement programmes

Companies featured in this report

Corporate Governance & Voting

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Aegis	UK	East Group Properties	US	Home Depot	US	Pantheon International	UK
Bank of America	US	Encysive Pharmaceuticals	US	Macquarie Bank	AUS	Pfizer	US
CA, Inc	US	ExxonMobil	US	Mazda Motor Corp	JP	Prodesse	UK
Cisco	US	Fuji Photo Film	JP	Mitsubishi Corporation	JP	Qantas Airways	AUS
Cox Enterprises	US	Groupe Bolloré	FR	MRMC	US	Sun Microsystems	US

Governance Bribery & Corruption

pages 8-9

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Abbott Laboratories	UK	Deutsche Bank	DE	Marks & Spencer	UK	SAB Miller	UK
AIG	US	Deutsche Telekom	DE	Merck	US	SAP	DE
Alcatel	FR	Devon Energy	US	Mizhuo Financial	JP	Schering-Plough	US
Allianz	DE	Eni	IT	Motorola	US	Shell	NL
Anglo American	UK	Ericsson	SE	NEC	JP	Siemens	DE
Apache	US	ExxonMobil	US	Nokia	NO	SONY	JP
AstraZeneca	UK	Freeport-McMoRan	US	Novartis	CH	Talisman Energy	CA
BAE Systems	UK	GE	US	Novo Nordisk	DK	Tesco	UK
BASF	DE	GlaxoSmithKline	UK	Pemex	ME	Toshiba	JP
BAT	UK	Hewlett-Packard	US	Peter Hambro	UK	Total	FR
BHP-Billiton	UK	HSBC	UK	Petrobras	BR	Vodafone	UK
BP	UK	IBM	US	Petrochina	CN	Volkswagen	DE
Burren Energy	UK	Intel	US	Premier Oil	UK	Woodside Petroleum	AUS
Chevron	US	Johnson & Johnson	US	Rio Tinto	UK	Wyeth	UK
Cimpor	PT	Kazakhmys	UK	Roche	CH	Xstrata	UK
DaimlerChrysler	DE	KazMunaiGas	KZ	Rosneft	RU		
Dell	US	Lonmin	UK	RWE	DE		

Environment Focus on Climate Change

pages 10-11

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Asda	UK	D1 Oils	UK	JP Morgan Chase	US	Shell	NL
Brasil Ecodiesel	BR	Deutsche Telekom	DE	Pacific Ethanol	US	Statoil	NO
China Sun Bio-Chem	CN	GE	US	Petrobras	BR	Verbio	AT
Clean Energy Brazil	UK	Global Ethanol	AUS	Petrotec	DE	Virgin Group	UK

Social Focus on Access, Security and Privacy

pages 12-13

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Aetna	US	Cisco Systems	US	Google	US	Yahoo!	US
Ahold	NL	Equifax	US	ING	NL		
AT&T	US	Expedia	UK	Microsoft	US		
BellSouth	US	Fidelity Investments	UK	Verizon	US		

Sector focus Aerospace & Defence

pages 14-15

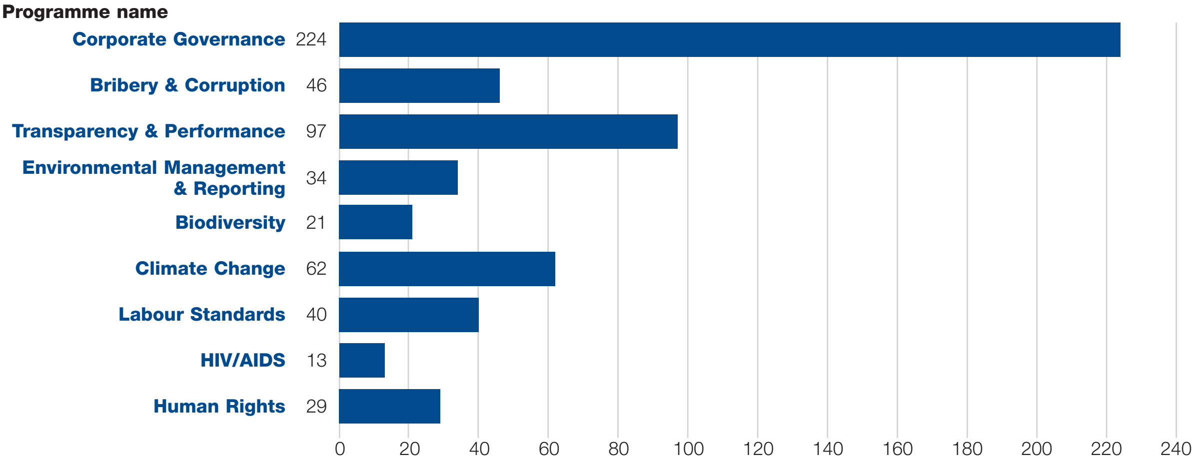
Company	Countries	Company	Countries	Company	Countries	Company	Countries
BAE Systems	UK	EADS	NL	Rolls Royce	UK	Titan Corporation	US
Boeing	US	Lockheed Martin	US	Smiths Group	UK		
Cobham	UK	Raytheon	US	Thales	FR		

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:

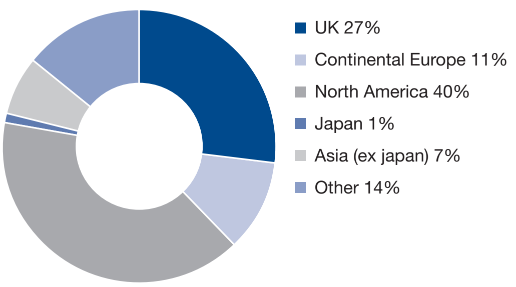
- A 15-person team of Governance & SRI specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary Global engagement – in all markets
- Comprehensive voting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

Number of companies engaged this quarter



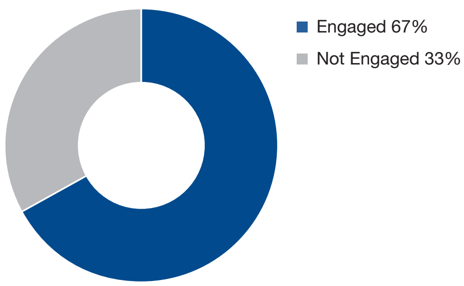
Total number of companies engaged this quarter[1]	350
Number of resolutions	4083
Company meetings voted[2]	652
Votes against management[3]	666
Corporate Governance engagement letters sent	327

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[4]



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	652	
Number of countries in which we voted	43	
Number of resolutions	4083	100
Total votes for management	3298	80.8
Votes against management	350	8.6
Abstentions	316	7.7
No vote	118	2.9

Analysis of votes

Issue	% for	% against	% abstain	% no vote
Routine business	91	1	6	2
Directors and governance structure	82	8	9	1
Capital	86	8	3	3
Mergers/reorg	89	5	4	2
Remuneration	70	12	17	1
Anti take-over	38	38	13	11
Others	81	7	7	5

Shareholder resolutions number of votes for or against management

for	against	abstain
10	13	6

Background

Fighting off the raiders: When companies turn to shareholders for help

One essential right enjoyed by UK shareholders is the ability to requisition an Extraordinary General Meeting (EGM) to address failures in management – but this was recently turned on its head when **Aegis**, a UK-based marketing services company, and **Prodesse**, a Guernsey-domiciled investment company, became the subjects of unwelcome attention by activist shareholders.

In the case of **Aegis**, its French competitor and large shareholder **Groupe Bolloré** had tried unsuccessfully to place two of its own candidates on the board at the recent AGM, in an apparent attempt to bolster its influence without paying a premium for control. **Aegis** had resisted this by rallying a majority of shareholders to vote against the outside candidates, but this prompted **Bolloré** to call an EGM a few months later to propose the same two candidates. This time, **Aegis** mobilised an even higher turnout and vote against the **Bolloré** candidates, with strong backing from F&C.

Meanwhile, **Prodesse** found itself under fierce assault from Laxey Partners, and Isle of Man-domiciled activist shareholder seeking to replace the board and wind up the company. **Prodesse** appealed to its shareholders to back its strategy and vote their shares in support of management. In the event, an astonishing 92.5% of shareholders voted, thereby securing the company's continued existence – again, with strong support from F&C. In both instances, F&C ensured that none of its stock was lent so as to maximise its support for management on these crucial voting matters.

Totting up the bonuses when the numbers don't add up

In January 2006, F&C tightened up its stance on pay by calling on companies to ensure that remuneration committees have the discretion to reclaim or 'claw back' bonuses and other incentive payments in the event that these were calculated on the basis of accounting figures later found to be inaccurate. Following active engagement by F&C over the last year, the influential UK Association of British Insurers, which accounts for a third of the UK stock market and is the leading authority on UK-wide corporate governance standards, has now updated its remuneration guidelines to reflect this principle.

... and making sure the auditors are accountable

This matter is of particular concern in the US, where **1,070 companies restated accounts in the first three quarters of 2006**[5] – too late to recover egregious overpayments to executives – while many others have been caught in an unfolding scandal over 'options backdating'[6]. F&C therefore insists that the selection of auditors be a matter for shareholder approval. We voted against those members of **MEMC**'s Audit Committee who were up for re-election, who failed to put its auditor to a vote despite a material restatement. We also opposed the auditors at **CA, Inc.** (formerly known as Computer Associates) and **Sun Microsystems** following restatements, and withheld support from the chairmen of the Audit Committees at **East Group Properties**, **Encysive Pharmaceuticals**, and **Cox Enterprises**, who did not put the auditors up for ratification on the grounds that they are not required to do so under the Sarbanes-Oxley Act.

We said...

"The remuneration committee should maintain authority to withhold or reclaim all or part of non-base pay (including cash bonuses, options and stock awards) from executives in cases where it deems it appropriate. ... At a minimum, substantial restatements of the financial accounts should trigger a reassessment of performance-based remuneration where this had been calculated on the basis of inaccurate figures."

F&C voting guidelines, January 2006

They said...

"Remuneration committees should consider legal redress where performance achievements are subsequently found to have been significantly misstated so that bonuses and other incentives should not have been paid."

ABI Guidelines, December 2006

Getting the right balance between audit competition and audit quality

Following the collapse of accounting firm Arthur Andersen, and the ensuing concentration in audit services, F&C favours broadening the choice of auditors available to companies, and encourages companies to consider tier A audit firms wherever these can meet necessary standards of competence and global coverage. As a member of the ABI Investment Committee, F&C is a signatory to the ABI's Letter on Auditor Choice[7], and also joined with five other institutions in a similar letter to the audit committee chairmen of the top 350 UK-listed companies[8]. Meanwhile, debate has also centred on the degree of protection auditors should enjoy in the event that one of their audits is deficient. While F&C welcomes the 2006 Companies Act's provision that companies who choose to limit auditor liability should ensure such a limit is fair and reasonable and subject to an annual shareholder vote, it also insists that any move towards limited auditor liability be matched by enhanced audit quality. We therefore voted against limitations to auditor liability at **Fuji Photo Film**, **Mazda Motor Corp** and **Mitsubishi Corporation** in Japan, and **Pantheon International Participations** in the UK.

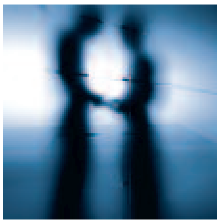
Independence: it's not just for auditors anymore

Along with several other institutional investors, including the states of Connecticut and North Carolina, F&C wrote to the 25 largest US companies to ask how their remuneration committee ensures the independence of their compensation consultants. Historically, information on consultants' identity has been secret– although new 2007 rules will change that – and investors cannot judge whether board consultants also have contracts with company management that could undermine the impartiality and quality of their advice. To date, we've received written responses from 11 companies, including **Bank of America**, **Cisco**, **ExxonMobil**, **Home Depot** and **Pfizer**. While some companies report an explicit prohibition against consultants working for management, many committees evaluate potential conflicts on a case-by-case basis or allow some minor work. As consultants may be a key factor in the US problem of spiralling executive pay, F&C will continue its work to define and promote best practice in this area through ongoing dialogue and possibly filing shareholder resolutions.

"Compensation consultants have become more powerful in the past few years as tougher governance rules have prompted most boards to rely on independent advice when setting executive pay. But their role has been largely shielded from public scrutiny…"

***Financial Times,* "Investors warn on use of pay consultants", 2 November 2006**

5 According to proxy advisory firm Glass Lewis.
6 Options backdating occurs when a board compensation committee awards stock options on one date, and then backdates the grant date to a time when the stock price was lower.
7 The ABI's Letter on Auditor Choice is available on www.fandc.com/new/aboutus/Default.aspx?id=63816
8 Letter available on www.fandc.com/new/aboutus/Default.aspx?id=63816



Focus on Bribery & Corruption

Our objectives

- Ensure that companies have effective anti-bribery and corruption policies and systems with a specific focus on agents, intermediaries and third parties, payments transparency, whistleblowing, political influence and facilitation payments

Engagement by F&C

Introduction

In 2006, F&C raised bribery & corruption with 110 companies, primarily in six sectors: Oil & Gas, Mining, Pharmaceuticals, TMT, Banks and Construction. Engagement focussed on two primary areas: political influence and transparency in the extractive sectors.

F&C engages companies on this subject because, in addition to distorting and de-stabilising markets, bribery & corruption can expose companies to legal liabilities and reputational damage, disadvantage non-corrupt companies and reduce transparency for investors seeking investment opportunities. In particular, increasingly strong legislation in OECD countries means that companies can be prosecuted for corrupt activities outside their home territories.

The recent example of **Siemens** demonstrates that, despite tightened legislation, such practices still occur even within the world's largest companies. In the **Siemens** case, six employees have been arrested over the alleged existence of a $265 million 'slush fund' used to win contracts through bribery. The company has responded by implementing a new whistleblowing procedure and re-writing its anti-corruption policy[9].

The **Siemens** case comes on the heels of corruption scandals at other blue-chip companies such as **DaimlerChrysler** and **Volkswagen**[10], raising serious questions as to whether German corporates have fallen behind international good practice in this field. F&C has engaged both these and others in Germany, including **Allianz**, **Deutsche Bank**, **Deutsche Telekom**, **RWE**, **BASF** and **SAP**, to press for improved standards.

> “**German economy poisoned with corruption.** The recent arrest of 4 directors of Siemens is not an isolated occurrence. In the last few years, embezzlement, slush funds and police raids on the headquarters of the cream of the German economy have become a mainstay of news coverage across the Rhine.”
>
> ***L'Express,* 'La corruption empoisonne l'économie allemande', 22 November 2006**[11]

Extractive Industries Transparency Initiative (EITI)

Investors have a strong interest in ensuring that the oil, gas and mining companies in which they invest have access to resources and can operate in a stable and predictable business climate, especially at a time when the most attractive reserves are often in politically unstable regions. The EITI is a G8 initiative that aims to persuade both host governments and extractive companies to undertake consistent and audited disclosure of taxes, royalties and other payments between extractive companies and host governments. The object is to reduce the opportunities for corruption and create more stable markets through increased transparency. F&C promotes the EITI in several ways:

- Representing the investment community on the EITI's Board, alongside government, multilateral bank and NGO representatives, as well as extractive companies **Anglo American**, **BP**, **Chevron** and **Pemex**[12]. F&C has been particularly active in promoting the message that strong verification procedures are needed for countries that claim to be implementing the EITI
- Leading the investment community in supporting the EITI, and coordinating the *'Investors' Statement on Transparency in the Extractives Sector'*. To date, over 70 investment institutions have signed the statement, representing over $12 trillion
- Supporting the two dozen companies already backing the EITI, such as **Royal Dutch Shell**, **ExxonMobil**, **Total**, **Eni**, **BHP Billiton** and **Rio Tinto**. F&C regularly engages senior management in companies supporting the EITI to ensure that company boards are aware that effective implementation of the EITI remains a priority for the investment community
- F&C systematically engages extractive companies to support the EITI principles. Among the companies that have declared support for EITI after engagement by F&C are **Burren Energy**, **Petrobras**, **Eni**, **Woodside Petroleum**, **Talisman Energy**, **Xstrata** and **Premier Oil**. F&C's attention is now turning to Emerging Markets companies, including **Kazakhmys**, **KazMunaiGas**, **Rosneft** and **Petrochina**, as concern grows that companies supporting the EITI will suffer competitive disadvantage vis-a-vis their Emerging Markets rivals unless there is a level playing field

9 Source: *Financial Times*, 1/12/06
10 Source: *L'Express*, 22/11/06
11 Translation by F&C
12 Current EITI Board members are joined by their Alternates, which are **Royal Dutch Shell**, **ExxonMobil** and **Petrobras**.

- In addition to engaging extractive companies, F&C is examining with its sovereign debt team whether implementing the EITI can improve the debt rating of host country governments. Tangible evidence of this would provide a strong incentive for host country governments to implement EITI effectively.

We said...

"In our business, the higher the risk, the smaller the sums of money we are likely to invest – and the higher the returns we would have to expect to justify being there at all. So here's the thing: the EITI promises to reduce the investment risk and contribute to more stable markets"

Extract from speech by Bob Jenkins, Chairman of F&C Asset Management, to EITI International Conference in Oslo, 16 October 2006

Political influence

In 2005, F&C sponsored the publication of *'The Ethics of Influence'* by the UK's Institute of Business Ethics, which examined how companies influence public policy through political donations and lobbying. This led F&C to issue new 6-step guidelines on how to ensure high standards of transparency, accountability and consistency with respect to corporate engagement in public policy development. The guidelines were sent to 358 companies, including 212 Emerging Markets companies that are seeking to establish themselves as multinational companies or raise capital from the international markets.

2006 has seen two important trends. First, a series of scandals in which political lobbying or donations have been a factor; and secondly, the emergence of best practice standards in an area that had been previously neglected.

F&C regards corporate involvement in the political process as both necessary and desirable to ensure that government policy and regulation reflect the practical constraints of the marketplace. However, experience has also demonstrated that this is vulnerable to abuse and manipulation, leading in extreme cases to criminal prosecution and fines, and more widely to reputational damage and deteriorating public trust.

When F&C's guidelines were first published, a number of companies resisted the idea of collating information about donations and lobbying positions across the organisation. However, several companies contacted by F&C have gone a long way to implementing the guidelines – including **BHP Billiton**, **Xstrata**, **Lonmin** and **British American Tobacco**. **BHP Billiton** lists industry associations of which it is a member and includes a chart listing "Examples of current government relations issues". **British American Tobacco** provides unusually extensive information about its approach to policy issues, including a link to the "Regulatory Engagement by Group Companies," which quantifies the specific tobacco-related issues the group companies are working on worldwide. The **British American Tobacco** report also discusses the fact that transparency on lobbying is an emerging issue on which the company is working actively. This is helpful to understand how the company is positioning itself in relation to the evolving regulatory landscape in different markets around the globe.

After a year of improving practice in this area, F&C recommends:

- Listing all trade association memberships
- Providing greater detail about significant partnerships with trade bodies and other politically-connected organisations
- Publishing summary data on the extent and nature global lobbying
- Providing links to official submissions to government
- Describing the system for vetting organisations to which donations are made, and the systems for awarding donations
- Detailed disclosure of the names of politically-oriented advocacy groups (including charities) that are funded, as well as the amounts and the programmes that receive funding.

Companies engaged by F&C on political influence in 2006

Oil & Gas	Pharmaceutical	Mining	TMT	Other
Apache	Abbott Laboratories	BHP-Billiton	Alcatel	American International Group
BG Group	AstraZeneca	Freeport McMoRan	Dell	BAE Systems
Chevron	GlaxoSmithKline	Lonmin	Ericsson	British American Tobacco
Devon Energy	Johnson & Johnson	Peter Hambro	Hewlett-Packard	Cimpor
ExxonMobil	Merck	Rio Tinto	Intel	General Electric
Petrobras	Novartis	Xstrata	International Business Machines	HSBC
Total	Novo Nordisk		Motorola	Marks & Spencer
	Pfizer Inc.		NEC	Mitsubishi Corporation
	Roche		Nokia	Mizhuo Financial Group
	Schering-Plough		SONY	SAB Miller
	Wyeth		Toshiba	Tesco
			Vodafone	

Focus on Climate Change

Our objectives

- Encourage adoption of clear, long-term government policies to shift to low-carbon economy
- Encourage all companies with substantial greenhouse gas (GHG) emissions to measure and minimise them, and publicly report on their strategy to manage the risks to their business posed by climate change.

> "No longer will the amount of CO_2 big companies produce come at a cost just to the environment. It is becoming increasingly clear that there will be a heavy cost to profits and share prices. The burning question is which companies will be hit the hardest."
>
> ***The Sunday Telegraph,* "The hidden cost of carbon", 5 November 2006**

Engagement by F&C

Introduction

The enormity of the challenge the world faces in dealing with climate change is hitting home. Intense public and media interest across the world is putting pressure on governments to respond. Policy frameworks remain somewhat patchy, and some countries are moving more quickly than others. But the direction of travel now seems clear – the question for investors is how quickly governments will act, and whether policy frameworks will be strong enough to drive a major shift in investment patterns.

F&C believes that climate change presents significant business risks and opportunities across a wide spectrum of the economy. F&C aims to influence governments to put in place robust, predictable policy frameworks, and to persuade companies of the need to think forward to what these frameworks may mean for their business model in the future.

The Stern Review is driving the political agenda…

The fourth quarter was marked by the UK Government's release of the *Stern Review on the Economics of Climate Change,* which is the most comprehensive analysis ever undertaken on the economics of climate change. The political reverberations will be significant. Two examples: in Australia, Prime Minister John Howard announced a taskforce to look into an emissions trading scheme for Australia, just two weeks after the Stern Review came out. And in the EU, President of the Commission José Manuel Barroso – said to have been persuaded by Sir Nicholas Stern's arguments – now says he wants the EU to be a leader in this area.

F&C, through the *Corporate Leaders' Group on Climate Change*[13], had actively contributed to this report by emphasising the opportunities that climate change presents to business, as well as the need for regulatory clarity over the long term so as to enable long-range investment planning. These two principles were clearly reflected in the Review's findings.

…and carbon markets are gaining momentum

The second major development this quarter was the European Commission's rulings on the Phase II National Allocation Plans governing the permitted carbon emissions of 10 of the 25 EU Member States. These rulings were seen as critical to the future of the European scheme, given the near-collapse in the carbon price in April 2006 when markets realised that governments had been overly generous in handing out Phase I permits. Thus, a soft approach by the Commission to Phase II could have sounded the death knell for the scheme's credibility.

But the decisions surprised many by their toughness. This reflected strong pressure by, amongst others, a group of 25 companies who wrote to President Barroso to call for tight caps, 17 of which (including F&C) met him to press the case. F&C played a key role in bringing the group together, persuading companies including **Deutsche Telekom**, **Statoil**, **Asda** (UK subsidiary of **Wal-Mart**), **General Electric**, and **JP Morgan Chase** that this was an important opportunity to influence the future direction of EU policy.

Of the ten Member States whose schemes were reviewed by the Commission, only the UK's was judged to be ambitious enough. This reflected strong lobbying by F&C via the Corporate Leader's Group for the UK government to set its cap at the lowest end of the possible range. Decisions on the remaining 15 schemes are still to come, and some member states are set to appeal. But F&C's expectation is that Phase II – which runs from 2008 to 2012 – will deliver genuine scarcity, and a more stable carbon price than the current phase.

Where to next

F&C's activities in 2007 will focus on two areas. First, company engagement, where we will be seeking evidence that companies have a sound strategy in place to meet the challenges of carbon pricing. And second, we will continue to work to shape policy. The key debate of 2007 will be on the design of the European scheme beyond 2012 – including how it can link up with other nascent schemes worldwide.

We said...

"The Stern report makes it clear that the global economy is poised to enter a phase of massive economic transformation, akin to the experience of the introduction of railways and electricity and, more recently, the global communications revolution."

Alain Grisay, *Petroleum Review*, "Low-carbon economy achievable", 1 December 2006

Biofuels zoom ahead...

Action on climate change is good news for companies involved in alternative energy. One area attracting significant interest is biofuels, which are emerging as a commercially viable low-carbon fuel. Biofuels are already a $15 billion/year market, and have recently seen a surge in investor interest reflecting growing government support. This, in turn, has been driven by three key factors: energy security; pressure from farmers, who stand to benefit from new demands for their crops; and climate change.

F&C expects that more governments will introduce a supportive regulatory framework for biofuels, such as tax breaks or mandatory fuel blending targets. Already:

- In Brazil, there are 3 million cars running exclusively on ethanol, while 80% of light passenger vehicles are "flex fuel" i.e. run on gasoline, ethanol or both
- The European Union aims for 5.75% of transport fuel to come from biofuels by 2010 and the USA aims to increase biofuel consumption from 4 billion to 7.5 billion gallons by 2012.

...but is there a cloud on the horizon?

F&C sees significant ESG-related concerns and threats to industry growth, including:

- Growth in fuel crops is likely to intensify competition for land between food, fuel and conservation uses; if deforestation accelerates, the CO_2 savings from biofuel production will be negated by the loss of carbon sinks
- Many methods of processing biofuels are highly energy-intensive, thereby achieving modest net savings of greenhouse gases
- Biofuel crops may be grown or processed using genetic modification, which holds promise for raising yields and cutting energy use – but remains a controversial technology in Europe and elsewhere
- Palm and soybean oils are emerging as popular low-cost feedstocks for biodiesel, but their production has been associated with damaging fragile ecosystems and endangered species.

The credibility of the "biofuels story" may be questioned if the technology fails to resolve these concerns; this could, in turn, prompt powerful environmental campaign groups to press governments and oil companies to withdraw support for biofuels.

F&C believes that biofuels companies can help to safeguard their favourable position if they can show that they have clear net positive impacts on greenhouse gas emissions and the supply chain. While they can tackle the land use question by sourcing sustainably-grown feedstock, supplies are limited and it can be difficult for individual biofuels companies to influence agricultural practices, particularly where supply is dominated by commodities traders. F&C believes that sector-wide initiatives to develop common standards are an appropriate response to the structural problems faced by a fledgling industry.

F&C has pressed biofuels companies to demonstrate a commitment to a more sustainable industry. Those that have indicated they will do so include **D1 Oils**, **Verbio AG**, **Petrotec**, **Petrobras**, **Brasil Ecodiesel**, **Clean Energy Brazil**, **China Sun Bio-Chem Technology**, **Global Ethanol**, and **Pacific Ethanol Inc.** F&C expects biofuels companies to:

- Understand and measure net greenhouse gas emissions to clarify whether the overall carbon impact is positive
- Publish a policy to source feedstock sustainably
- Participate in industry initiatives such as the Roundtable on Sustainable Palm Oil[14], and the equivalent under development for soy.

Certain industry players, such as **Shell** and the **Virgin Group**, are investing in second-generation technologies such as "cellulosic" biofuels, which can be produced from a wide range of feedstocks, including agricultural and urban waste. These may emerge as a viable long-term solution, but in the interim F&C expects biofuels will attract both increased investment and increased public scrutiny.

They said...

"The present assessment regarding the sustainability of first and second-generation biofuels is entirely unsatisfactory... One biofuel is not the same as another: some first-generation biofuels... have a worse CO_2 balance than conventional gasoline fuels, but nevertheless still bear the name of 'biofuel'. First-generation biofuels receive tax incentives from scarce budget resources... That cannot be considered sustainable in either the ecological or the economic sense of the word."

Bernd Pischetsrieder, Chairman of VW, *Euractiv.com*, 24 October 2006

13 The Corporate Leaders Group on Climate Change is a group of 19 companies who believe that there is an urgent need to develop new and longer-term policies for tackling climate change. Details of previous activities of the Group were reported in the Q2:2006 ***reo***® report.

14 The Roundtable on Sustainable Palm Oil is a global initiative, launched in 2004, to bring together stakeholders along the palm oil supply chain to encourage more sustainable practices. The Q4:2003 ***reo***® report sets out the issues involved in palm oil sustainability, and the Q1:2006 report gave an update on F&C's work with the Roundtable.

Focus on **Access, Security & Privacy**

Our objectives

- Evaluate access, security and privacy risks facing technology and telecommunications companies
- Identify emerging good practice and raise awareness of the issues
- Determine management strategies to safeguard long-term shareholder value

Engagement by F&C

E-challenges: Free access to information vs customer privacy and security

Individuals around the globe have quickly adapted to the electronic age, snapping photos from mobile phones, paying bills electronically, and swapping personal information through online social networking websites. Such dramatic shifts in consumer practices have led to explosive growth in the tech sector, but such widespread "digitisation" is also fuelling concerns about the role technology can play in *exposing* customers to privacy threats and *limiting* individuals' access to information. For example:

- A steady stream of headlines in 2006 announced major data security breaches at **ING**, **Ahold**, **Equifax**, **Aetna**, **Expedia** and **Fidelity Investments**, which put individuals' personal data into the wrong hands
- **Verizon**, **BellSouth** and **AT&T** are facing at least 20 class action lawsuits for alleged consumer privacy breaches after turning over customer calling records to US intelligence authorities
- Human rights watchdogs have accused technology companies of complicity in human rights abuses. In February 2006, **Microsoft**, **Yahoo**, **Google** and **Cisco Systems** were summoned to the US Congressional Subcommittee on Global Human Rights to explain how their business policies and products might be contributing to Internet censoring and privacy violations in China

F&C acts

In order to understand how these factors interact with industry business drivers, F&C undertook a full-scale review of the Access, Security and Privacy (ASP) risks faced by technology, media, and telecommunications (TMT) companies. This consisted of in-depth interviews with 13 companies across three TMT sub-sectors, as well as outside academic and NGO experts. The report, entitled *Managing Access, Security & Privacy in the Global Digital Economy* and published in January 2007, highlights the serious challenges and dilemmas the TMT sector faces in responding to ASP risks, and identifies emerging areas of good practice.

Why did F&C undertake this study?

As customers face the kinds of ASP threats noted above, TMT companies face an emerging risk to their business models. If users cannot rely on their confidential data being secure or on accurate Internet search results, the sector's growth will be constrained. F&C's study aims to investigate these central questions by looking at how companies are responding to ASP risks and the business impact they may have on TMT companies.

What does ASP mean and why does it matter?

- **Access** refers to the ability to obtain information on the Internet and distribute ideas at will. Companies struggle to balance competing demands to allow broad access to information on the Internet, limit access to adult content by children, and restrict content in line with different national standards
- **Security** refers to the ability to protect customers, data and systems from outside interference and only make them available to authorised personnel. As companies store more data, and data become more mobile, new opportunities for theft and corruption arise
- **Privacy** refers to the ability to protect or safeguard personal information and confidentiality. Companies face competing pressures to protect consumer privacy and confidentiality, and yet release data to law enforcement officials to support the fight against terrorism and online predators.

What problems have companies faced?

- Companies operating in countries that restrict access to information on the Internet face the dilemma of meeting the demands of national law, while also meeting the expectations of the international community to respect freedom of expression and information. Companies operating in countries such as China, Cuba, Syria and Zimbabwe face this challenge on a daily basis, but still strive to provide Internet access to Emerging Markets customers
- TMT companies are driven by consumer demands to make data portable on laptops, Blackberry™ devices and through wireless networks. However, mobile data are inevitably vulnerable to theft or neglect, and criminal elements operating in the digital economy have also become savvier at cracking data that are transmitted through different technology devices. Companies struggle to protect data security while enabling data mobility
- The rise of online criminal activity and terrorism has led law enforcement authorities to call on companies to turn over data records and provide evidence in criminal

prosecutions. Companies face a conundrum of protecting consumer privacy and meeting legitimate legal requests for confidential user data

- As the market for technology products widens, companies are also beginning to struggle with the indirect impacts of their products, e.g. how their products will ultimately be used by customers. If company products are used for illicit or unethical purposes, technology providers face growing accusations of complicity amidst uncharted legal territory.

How should companies respond?

F&C's study lays out a series of good practice recommendations for companies to tackle these issues, including:

- **Establish "Know Your Customer" guidelines to avoid enabling illicit or unethical activity.** Similar to anti-money laundering guidelines, companies can establish indicators of high-risk customers who might use technology products for harmful purposes

- **Develop clear policies and processes for responding to law enforcement requests for customer data.** This should guide employees in protecting customer privacy while fulfiling legitimate requests to assist in criminal investigations

- **Establish cross-functional committees to manage ASP issues.** Engineers, lawyers, compliance managers, and business development executives need to collaborate in new product development and marketing to ensure that all parts of the business fully address ASP challenges

- **Educate and empower customers to control their own technology experience.** Companies should empower customers to control what content enters their homes or offices, and inform them of any government-ordered content restrictions. This is a particular concern in heavily censored markets such as China, where companies should let users know when information has been blocked, and block content only in the country that requires it. Companies should also educate customers about data privacy standards and self-protection methods such as passwords, changed security settings, etc…

What will F&C do next?

F&C believes that a more robust approach to ASP will allow TMT companies to develop new standards to address these challenges, which are aggravated by regulatory uncertainty and cultural and legal differences across boundaries. As new technologies emerge and more personal information goes digital, ASP risks will snowball, but by confronting these issues, TMT companies will be better equipped to do what they do best: develop innovative technologies that meet customer needs – including the need to protect Access, Security and Privacy. In 2007, F&C will continue its engagement with the TMT sector, encouraging companies to meet the good practice standards identified in its report.

"For foreign companies, the internet business in China is certainly a moral minefield. …The committed few who are brave or foolhardy enough to use the internet to challenge the authorities now face a police force of some 30,000 online monitors."

***The Economist,* "The party, the people and the power of cyber-talk – China and the Internet", 29 April 2006**

We said…

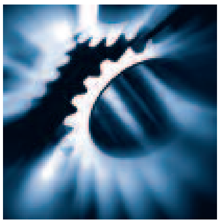
"Companies need to place ASP issues at the core of their business strategy if they are to keep ahead of the competition, anticipate customer needs and win the trust of society at large."

F&C, *Managing Access, Security & Privacy in the Global Digital Economy,* December 2006

They said…

"Figuring out how to deal with China has been a difficult exercise for Google. The requirements of doing business in China include self-censorship – something that runs counter to Google's most basic values and commitments as a company."

Elliott Schrage, Vice President, Global Communications and Public Affairs, Google, Testimony before the Subcommittee on Global Human Rights, US House of Representatives, 15 February 06



Focus on Aerospace & Defence Sector

Facing up to twin challenges

Attitudes of governments and regulators have been hardening in two areas that present enormous challenges for the sector: bribery & corruption, and climate change. How companies respond will help differentiate the winners and losers in the medium to long term. F&C's view on the sector and climate change ('An industry in denial?') will be published in next quarter's ***reo***® report; for this quarter we focus on the topical issue of corruption.

Aerospace & Defence companies have been laggards when it comes to environmental, social and governance (ESG) performance, not least because their customers – governments – have ranged from undemanding to, in the worst cases, tolerant of shady practices. So why should ESG practices matter now? First, the expectations of civil society and employees have increased. Second, government customers are tightening up – sometimes via regulation. Third, and most important, a reputation for bribery increases investment risk, while responding proactively to climate change can translate into competitive advantage.

However, the sector has started to wake up, acknowledging these issues and becoming more transparent. Despite its legacy issues (see below), **BAE Systems**, in particular, has improved – which is important, as hundreds of smaller UK sub-contractors tend to fall in line with the industry giant.

Bribery & Corruption

Introduction

Critics of the defence sector have long claimed that bribery & corruption is endemic – particularly in securing large arms deals with governments in developing countries. They contend that even the 'official arms trade'[15] is a murky world. This has been exacerbated by the fact that under the cloak of national security or commercial confidentiality, defence companies have revealed very little about the nature of their operations.

Is corruption built into the system?

Traditionally, defence companies have been considered strategically important because they help to maintain a national arms capability and a technological and industrial base, while weapons exports strengthen strategic alliances between states.

Companies may therefore find themselves selling arms overseas to regimes that are strongly criticised for their records on human rights – with the tacit, and sometimes explicit, encouragement of their home governments, who may not have enquired too deeply about the methods used to secure contracts. Faced with competitors that are paying bribes, and that have the support of their country's trade and diplomatic staff, companies have resorted to the same tactics in the name of 'levelling the playing field'.

Changing scenario: the war on terror

However, the US government has notably tightened its procurement guidelines to ensure that corruption is stamped out in its own back yard, and made it clear that companies that continue to offend will be debarred from the huge US domestic market. A key driver has been the 'war on terror', which has led to a clampdown on illegal, concealed money flows. For defence companies, previously tolerated behaviour falls on the wrong side of the law.

Whereas corruption in the defence sector had previously posed an ethical dilemma that was routinely swept aside in the interest of pragmatism, it has now become both a legal and commercial factor that fundamentally conditions a defence company's ability to survive.

The risk of getting it wrong

The immediate danger for defence companies is that they will step the wrong side of increasingly complex laws. This can lead to fines, loss of contracts, regulatory delays for future commercial activities such as takeovers and, most significantly, 'debarment' status with the US government – closing the door to the world's largest customer.

Two examples in the US market are the termination of seven US Air Force contracts with **Boeing**, worth US$1 billion, after three employees were indicted for fraud; and the collapse of **Lockheed Martin's** $1.8 billion acquisition of **Titan Corporation**. This happened after **Titan** failed to reach a settlement with the US Department of Justice over allegations of bribery in Africa.

The implication is that companies can no longer afford to compromise on standards if they want to stand a chance of competing for business in the world's single largest market.

The legacy issues

Many companies in the sector are also faced with so-called legacy issues – or skeletons in the wardrobe. Legacy issues are most likely to affect companies that used sales and business techniques until very recently that would be illegal today – even though they were legal – or in a legal grey area – at the time. It is by no means clear how companies should deal with such issues, but when they come to light, they can be very damaging to a company's reputation.

An example of the paradox caused by legacy issues is the recent furore over **BAE Systems**' potential £40 billion contract with Saudi Arabia. Previous such deals, struck more than a decade ago, were the subject of a two-year long investigation by the UK Serious Fraud Office, which the UK government abruptly abandoned in mid-December following heavy lobbying by **BAE Systems**, who feared losing the Saudi contract to a French rival. This exemplifies how allegations and subsequent investigations related to corruption can severely disrupt relations between companies and their customers, causing project delays and significant reputational damage.

It is hard not to conclude that if the company had earned a reputation for possessing rigorous anti-corruption systems, it would not have faced the SFO enquiry and its effects, which have yet to play themselves out fully. The paradox is that, had the company been operating to such standards, it might not have secured those contracts in the first place – but lost them to less scrupulous competitors.

F&C believes this strengthens the case for industry-wide anti-corruption initiatives to be introduced as soon as possible, to avoid the seeds of future legacy issues being planted today. In addition, F&C has written to the UK Minister of Defence Procurement noting that the government risks appearing to condone corruption and this is not in the long-term interests of sustainable capital markets or shareholders.

We said…

"We appreciate the action that the Government, and you personally, have undertaken in supporting anti-corruption discussions across the aerospace & defence sector, but believe the SFO affair has given new urgency to their achieving a real and substantial outcome. We strongly recommend that the government give full and visible support to such initiatives at UK, European and global levels. Indeed, to achieve a level playing field in which UK companies are not disadvantaged commercially by agreeing to rigorous anti-corruption procedures, such initiatives must be pursued at international level. We look to the Government to increase its efforts in this regard."

Extract of letter from Karina Litvack, F&C Asset Management to Lord Drayson, UK Minister for Defence Procurement, 19 December 2006

Policies: A… implementation: C

The largest companies have now significantly improved their policies and codes of conduct: but in companies with tens of thousands of employees, how does one make sure everyone has got the message that the old ways of doing business have suddenly changed? It only takes the action of one over-enthusiastic employee to taint a company's record, and the systems that have for decades incentivised such behaviour take time and thought to change.

Responding to the anti-corruption challenge

F&C has engaged companies throughout the sector, including **BAE Systems**, **Rolls Royce**, **Thales**, **Lockheed Martin**, **Boeing** and **Smiths Group**, with a focus on three areas:

- **Promoting best practice** through engaging companies on use of agents, codes of conduct that specifically reference bribery & corruption, greater disclosure on political lobbying and donations, internal compliance and reporting systems (a.k.a. whistleblowing), and publishing performance results
- Within the UK, supporting calls for **tightening anti-bribery provisions in export credits**, in response to *The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*
- **Industry-wide anti-corruption initiatives.** F&C strongly supports the move, first promoted by anti-corruption group Transparency International, to establish a sector-wide anti-corruption initiative. This would raise standards across the sector and overcome the argument that individual companies wanting to act on bribery place themselves at a commercial disadvantage in the race for contracts. The early supporters of such an initiative, **Lockheed Martin**, **Raytheon**, **Thales** and **Smiths Group**, have recently been joined by **BAE Systems**, **Rolls Royce** and **EADS,** with smaller companies such as **Cobham** following in their wake. Two significant steps forward were announced at the Farnborough Air Show this year: the creation of a UK-based Defence Industry anti-Corruption Forum, and a European-wide Ethics and anti-Corruption Working Group. It remains to be seen what these initiatives will accomplish and whether they can join forces with other regions to form a genuinely global approach: but these are positive first moves.

F&C's view:
where does the sector go from here?

Overall, F&C believes the sector needs to go further and faster in addressing its key challenges, and the largest companies need to take the lead. Specific areas in which F&C sees the need for future developments are:

- The merging of local and regional anti-corruption initiatives into a global initiative, with clear objectives and targets – along with evidence that they are genuinely going to reduce corruption and not simply talk about it
- A strategy for dealing with legacy issues: they are difficult and embarrassing, but pretending they do not exist can be counterproductive
- A wider acknowledgement that confidentiality does not preclude transparency; this should go hand in hand with improved reporting, and, in particular, a willingness to report progress on sensitive areas and greater disclosure on political lobbying – particularly when powerful trade associations act on behalf of their members
- Better governance of Corporate Responsibility, to increase confidence that policies are turned into practice.

They said…

Fears over Saudi arms case climbdown

"Karina Litvack, head of governance and sustainable investment at F&C...told the Financial Times on Thursday that the boost to BAE's share price was secondary to the "wider public governance issue". "The broader implications [of suspending the SFO investigation] is that it could undermine the integrity of capital markets"."

***Financial Times,* 21 December 2006**

15 The 'official arms trade' is defined as legitimate sales of defence systems to governments, as opposed to the black market in second-hand, stolen or banned equipment

Products

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

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