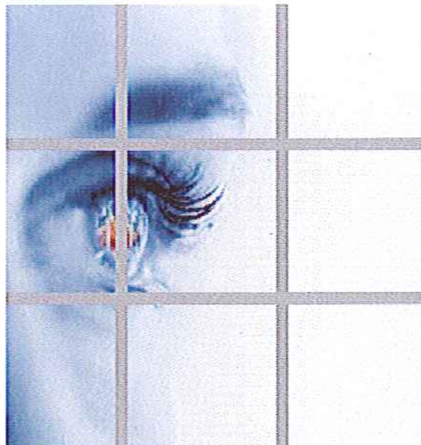


reo® viewpoint

Engagement Activity Report Q1 2011

Activity report: How *reo*® implements your responsible investment commitments

F&C's responsible engagement overlay is unique in the depth and breadth of its engagement, and in its ability to help clients implement their own commitment to responsible investments. Key features are:

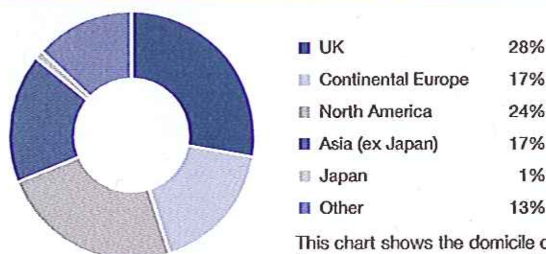
- A 18-person team of Governance & Sustainable Investment specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary
- Global engagement across all markets
- 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

Programme name	Number of companies engaged
Corporate Governance	79
Business Ethics	86
Sustainability Management & Reporting	83
Environmental Management	57
Ecosystem Services	73
Climate Change	59
Labour Standards	56
Human Rights	39
Public Health	18

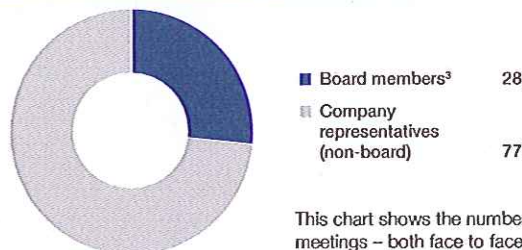
Total number of companies engaged[1] this quarter	202
Number of countries	31
Company meetings voted[2]	815

Geographical spread



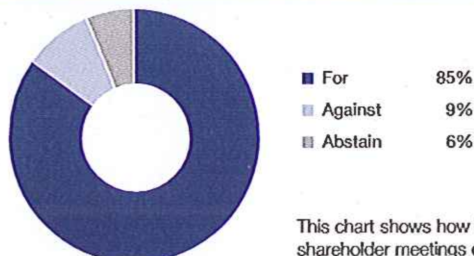
This chart shows the domicile of companies that have been engaged by F&C in the last quarter.

Number of company meetings



This chart shows the number of company meetings – both face to face and by telephone – carried out by F&C this quarter.

Resolutions at shareholder meetings



This chart shows how F&C voted at shareholder meetings over the past quarter.

Reasons for Votes Against Management

This chart shows the reasons why F&C has voted against management 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 Includes Named Executive Directors in the US.

F&C Investments

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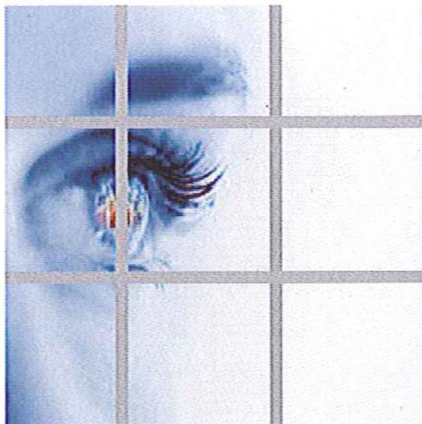

reo® viewpoint

Sagarika Chatterjee, Associate Director, Governance & Sustainable Investment
Alexis Krajeski, Director, Governance & Sustainable Investment

March 2011

The Great Leap Forward – 2.0: China's Climate strategy leaves rivals in the dust

This month, the People's Republic of China leapt down a low-carbon development path, approving a new Five-Year Plan that includes slashing energy intensity and carbon intensity by 16% and 17% by 2015, respectively. By focusing on "seven strategic industries", China will push hard on energy conservation, environmental protection, new energy technologies, electric vehicles and high-speed rail. This is a landmark decision from the world's fastest-growing economy, positioning it as a leader in green economic growth.

Not to be outdone, other major emerging economies are also starting to take action, following a long period of insisting that the West take the lead. South Korea had led the way in the aftermath of the 2008 crisis with a $38.1 billion green stimulus package focused on environmental infrastructure projects, and has since reinforced this with further measures including the introduction of a pilot emissions trading scheme and a target to certify all buildings for energy efficiency by 2012. In 2011, India will launch a new energy-efficiency trading scheme based on government-issued energy efficiency certificates. And finally, even Brazil, which is poised to become the 'next Saudi Arabia' thanks to its vast discovery of deepwater 'pre-salt' oil, has committed to reducing emissions by 26-29% by 2020 against a business as usual trajectory – despite plans to ramp up domestic oil refining capacity.

What do China's new plans mean for companies?

With such stretching targets and green economic policies in place, Chinese companies have clear incentives to take action on climate change. They also raise alarm bells for laggards. In 2011, F&C will urge carbon-intensive companies like **China Shenhua** and **Aluminium Corporation of China** to develop strategies to reduce the overall carbon intensity of their output, while still growing the business to meet surging demand.

As F&C went to press, China announced it would suspend approval for all new nuclear power plants in the wake of the Japanese nuclear crisis. Nuclear is an important component of China's new Five-Year Plan, and this decision raises new challenges for how the country will meet its ambitious targets – particularly that of raising the share of energy consumption from non-fossil fuels to 11.4% from 8.3%. F&C will monitor the implications of this latest decision and any subsequent policy changes.

Sweet and sour – Investors see modest results from global policy push

While China and others power ahead with strong national government policies, progress on crafting a successor to the Kyoto Protocol remains mired in political paralysis. Yet unless a global, legally-binding treaty can be hammered out by 2012 when Kyoto expires, the risk of severe economic, social and environmental damage from climate change remains high. No deal can be viable without the US, historically the world's largest global emitter,[1] yet domestic political opposition has stymied moves to reduce GHGs or pass a cap-and-trade scheme. F&C does not expect a global climate treaty to be signed until after the 2012 US presidential elections – and possibly not until 2014.

Nevertheless, at the latest round of global climate negotiations at Cancún in December 2010, specific policy demands made by F&C and fellow investors in four important areas achieved notable progress:[2]

- **Low-carbon technology:** In a critical breakthrough for facilitating technology transfer to emerging markets, governments agreed a framework for improving international co-operation on technology. This includes establishing a climate technology centre and network for developing innovative solutions to climate change. F&C welcomes this new framework, but for further progress, clear agreement is needed how exactly intellectual property rights will be protected.
- **Curbing deforestation:** "REDD[3]" was formally launched, enabling developing countries to obtain funds to protect standing forests, restore degraded areas, and achieve low-cost carbon reduction through avoided deforestation. Having pressed hard for this landmark agreement, F&C will continue to call for progress on next steps to turn REDD into practical financing mechanisms, e.g. by linking it into existing carbon trading schemes such as the EU emissions trading scheme (ETS).
- **A Green Climate Fund:** Managed by the World Bank, the fund will mobilise up to $100 billion in financial flows to developing countries by 2020. The focus will be on accelerating adaptation to climate change in emerging markets, but F&C is calling for clarity on who will provide and receive this money.

F&C Investments

1 In 2008, China surpassed the US as the largest emitter of greenhouse gases per annum, but on a per capita basis, the US is still regarded as the dominant emitter by a margin of over 450%, based on figures from the International Energy Agency.
2 *Global Investor Statement on Climate Change: Reducing Risks, Seizing Opportunities & Closing the Climate Investment Gap*
http://www.iigcc.org/__data/assets/pdf_file/0015/15153/Global-Investor-Statement.pdf
Cancún Communiqué: A call from business for ambitious, robust and equitable global action on climate change
http://www.cpsl.cam.ac.uk/pdf/The%20Cancun%20Communique%202010.pdf
3 Reducing Emissions from Deforestation and Forest Degradation in Developing Countries

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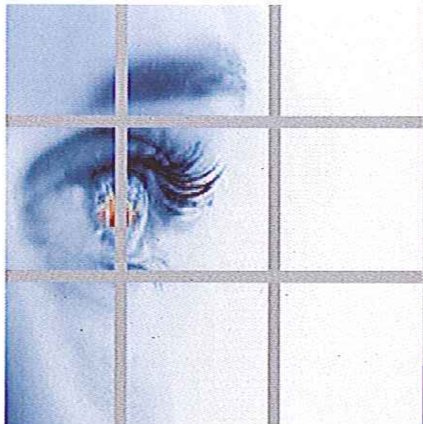

reo® viewpoint

- **Credible emissions monitoring:** New UN guidelines were agreed to assess compliance with emissions reductions targets, as well as rich countries' delivery on pledges to fund support for developing countries. This is the cornerstone of a future global deal on climate change, as it holds governments to their promises both to pay for reductions and to report accurately on results.

What action will F&C call for on a post-Kyoto deal in 2011?

Despite the gloomy political prognosis, F&C will maintain pressure on government policy-makers to press on with efforts to craft a post-Kyoto deal that includes China and the US: in the long term, this is essential for creating a level international playing field and efficient economic system. In the near term, however, our focus will be on the 'art of the possible': we will encourage governments to forge ahead with ambitious national policies for emissions reduction and adaptation to climate change, even though we accept that this will inevitably lead to inconsistent and potentially conflicting policy frameworks across jurisdictions. This should help build the case for coordinated global policy action over time.

F&C Assessment and Next Steps

Although the outlook for a global deal remains uncertain, companies still need to respond effectively both to the ever-growing physical effects of climate change and to tighter policies in markets like China and the EU. F&C will call on companies to take the following action in 2011:

- **Prepare for tougher government policies:** The EU, for example, has established an emissions reduction target of at least 20% – and possibly 25% – by 2020 (on 1990 levels), with specific incentives to encourage energy efficiency. F&C will encourage companies across sectors from real estate to electric utilities to airlines to develop and disclose business-relevant climate change strategies so they are well positioned for tougher EU regulation.
- **Reduce emissions, find climate change solutions:** F&C will encourage companies to measure, manage, and disclose greenhouse gas emissions. For companies dependent on carbon credits generated under the Kyoto protocol, F&C encourages clear disclosure about the assumptions made about the future of carbon trading and how those assumptions would impact the income statement. F&C also encourages companies to develop product opportunities from climate change trends.
- **Adapt to a changing climate:** Recent flooding in Australia has significantly affected coal mining assets, while extreme weather events have contributed to food price inflation and social unrest in Tunisia, Egypt and Libya. In China, two-thirds of Chinese wheat production is threatened by drought. In light of these growing food security threats associated with changing weather patterns, F&C will press food companies to adapt their supply chains to climate change.

In addition, F&C will continue to support collaborative initiatives including the Institutional Investors' Group on Climate Change, Carbon Disclosure Project, UN CEO Water Mandate and Forest Footprint Disclosure Project.

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reo® viewpoint

Alexis Krajeski, Director, Governance & Sustainable Investment March 2011

Calling for Change – How the humble mobile phone sparked a revolution in Egypt

Have you ever used Facebook on your mobile phone?

To spark a revolution?

As the Arab world grapples with an unprecedented wave of social protest, what is the spark that lit the fuse that sent tens of thousands of youthful protesters out to defy their leaders after decades of cowed silence? The answer lies in advanced telecom and technology applications. Indeed, events leading up to mass protests in Egypt's Tahrir Square started with a Facebook page entitled "We are All Khaled Said", which decried widespread police brutality throughout Egypt. This internet posting sparked a wildfire of activity on the web, including video links on YouTube and a frenzy of Twitter calls for Egyptians to stand up for freedom and human rights. In the weeks that followed, young people throughout the country used their mobile phones and the internet to come together in peaceful protests that ultimately brought an end to the 30-year rule of President Hosni Mubarak on 11th February.

Have you ever had a dropped call on your phone or lost your internet connection?

Because the government wanted you to keep quiet?

Even as the above events were unfolding, Egyptian government agents were seizing control of the telecoms network in a bid to locate dissidents and control protestors – ostensibly to protect national security and public order. The sequence of events below illustrates the breadth, depth and speed of efforts used by the government to control this important pipeline of information:

twitter

We can confirm that Twitter was blocked in Egypt around 8am PT today. It is impacting both Twitter.com & applications. (1/2)

twitterglobalpr

- 25 Jan – State Security Intelligence Service blocks Twitter following calls to mobilise in Tahrir Square
- 26 Jan – Facebook is blocked and the first people posting comments are arrested
- 28 Jan – Internet service and all mobile telecommunications are cut off. The author of the "We are All Khaled Said" page is arrested
- 29 Jan – Mobile phone voice services resume, but SMS messages within Egypt are blocked, except to foreign numbers
- 30 Jan – Text message distributed through all major mobile phone networks calling for "honest and loyal men to confront the traitors and criminals and protect our people and honour". Message is signed "Lovers of Egypt", but it emerges that the Egyptian intelligence service ordered the campaign
- 2 Feb – Internet service resumes but SMS messaging is still suspended. Intelligence service sends additional SMS messages
- 5 Feb – All internet, voice and SMS services are restored
- 11 Feb – Mubarak resigns

In a mere two and a half weeks, Egypt saw its political discourse transformed thanks to the central role telecom and technology services played in unleashing freedom of speech, assembly and political opinion. At the same time, events also highlight the quandary telecom and technology companies face when critical stakeholders – customer and regulators – square off in fierce opposition, leaving companies caught in the middle.

F&C: A history of engagement on Free Expression & Privacy

F&C first spotted this challenge back in 2006, when it published a report entitled Access, Security & Privacy in the Global Digital Economy. In that report, we outlined key business risks facing telecom and internet companies, including threats to the freedom of expression, privacy and data security rights of customers and employees. Recent events also highlight the financial implications of social unrest for investors. According to Forbes magazine, the estimated lost revenues due to these service interruptions in Egypt over the period was $110 million.

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Since 2006, F&C has engaged over 14 companies across the telecom, media and technology sectors, asking how they were managing these risks across their business. We outlined over 20 indicators of good practice and encouraged them to develop a governance framework and internal controls for managing such risks. F&C has also been partnering with other stakeholders and experts on free speech and technology to develop a set of industry standards. The result, in 2007, was the launch of the Global Network Initiative, a collaborative approach to protect and advance freedom of expression and privacy in the information and communication technology sector. As of January 2011, members of the GNI included three companies – Google, Microsoft and Yahoo – as well as a number of investment firms, human rights-related NGOs and investors.

Despite some contact with telecom operators in the early development of the GNI and repeated overtures to them to join, as of January 2011 none had elected to do so. Recent events in Egypt highlight just how difficult these challenges are for telecom operators, and the urgent need for them to develop a coordinated industry response, similar to the one adopted by internet and software providers under the GNI.

With the old rules out, how should companies respond?

And with mounting risks, how can investor engagement help companies prepare?

European telecom giants **Vodafone** and **France Télécom** both operate mobile telecom businesses in Egypt, and saw first-hand how government intervention during a political crisis could cripple freedom of expression and threaten revenues. But the answer to our questions is much less clear, particularly when the more basic question, "Who's in charge?" is so unclear.

In the wake of these events, F&C has redoubled its engagement efforts with telecom operators and technology companies. Although these events are difficult to respond to, they are not totally impossible to foresee and therefore prepare for. We've focused our engagement on the following key areas of good governance and internal controls, and are asking probing questions, such as:

- Who decides when the company will comply with government demands that raise ethical dilemmas, e.g. to turn off the network, disseminate government information, or hand over private customer data? How is the decision made?
- Does the board make the final call in such circumstances or the local operating company?
- Does the company have a framework for determining when a request is a legal obligation and when it a political request? Who makes this call and how is it escalated? What legal liabilities arise in either scenario?
- How does the company weigh up the risks to its local employees of suffering pressure from the authorities for not complying with government demands, versus the potential damage to customer privacy and human rights if they comply with those demands?

While the answers to these questions are rarely simple, it is always better to ask them early, i.e. before crisis strikes, so that business continuity plans can be in place to respond as effectively as possible to these scenarios. As political unrest continues to spread across the Middle East, North Africa and potentially even as far as China, with suggestions of a 'Jasmine Revolution' being rumoured online, telecom and technology companies cannot afford to sit back and wait for these issues to hit them. F&C will continue to engage companies facing risks related to free expression and privacy and will report in more detail on specific company engagement and outcomes to ***reo***® clients in the Q1 2011 ***reo***® Confidential Report.

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reo® viewpoint

George Dallas, Director, Corporate Governance

February 2011

Credit quality as a bonus underpin

Background

In the aftermath of the financial crisis, bank remuneration remains a critically sensitive issue for stakeholders, particularly for systemically important financial institutions that received government bailouts. While many of these institutions are beginning to recover, the negative effects of increased public debt incurred to protect the financial system have resulted in serious and lingering economic problems in many countries, including the UK. The impact of public sector balance sheets absorbing banking sector losses has also contributed to sovereign debt crises in peripheral European economies- which will continue to burden investors, taxpayers and the wider economy for many years.

With many economies facing severe deterioration in public finances and fiscal retrenchment , the legitimacy of granting substantial bonus awards to executives of systemically important banks, particularly those that have benefited from state support continues to be controversial and a high–profile issues. Whilst the media may revel in "banker bashing" this not merely a populist agenda and investors have serious and legitimate concerns about the awarding of substantial bonuses and that raise calls for a fundamental re-think of financial incentives for bankers. As an asset manager F&C recognises bank remuneration as a key concern of its institutional clients, who want us to address this problem, as both shareholders and creditors.

There are no easy answers. To compete in a complex environment, rebuild financial strength and wean themselves from state support, banks need to attract and retain capable managers in a competitive marketplace for executive talent. As investors we recognise that banks' ability to pay competitive salaries and to reward success is a commercial necessity.

At the same time, we believe that bank remuneration structures remain problematic, and that even broad regulatory reform frameworks, such as the G20 Principles and the more recent FSA Remuneration Guidelines, have not resolved all the outstanding concerns. We are disappointed by the banking sector's inability to work together to show pay restraint, and believe that even with the many reforms now in place bank remuneration and in particular the granting of bonuses, will continue to be an area of controversy.

Bank remuneration and moral hazard

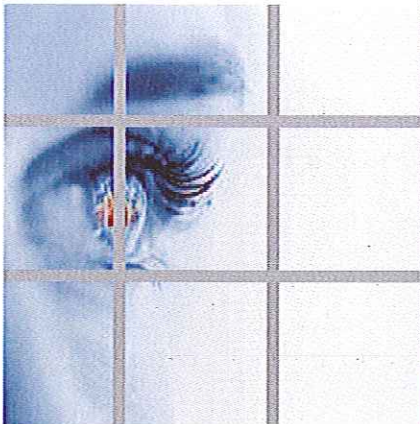
Specifically, we still have not cracked the asymmetry of reward problem sufficiently with banks. In good times, bankers can make fortunes both at executive and sub-board levels of the organization, but in a crisis the state, and ultimately the tax payer has to bail-out the bankers because of banks' systemic importance to the economy. This moral hazard issue is a particular feature of the financial sector, and is why, in part, we have seen specific attempts, including the Walker Review and the recent European Commission Green Paper to frame corporate governance issues specifically for this sector. For systemically important banks, where the state is an implicit guarantor because of the "too big to fail" concern, it is critically important that these banks manage themselves to avoid not only default but also a severe deterioration in standalone credit quality that could result in significant operational and financial impacts. Incentive systems could, and should, be aligned to meet achieve this primary objective for financial institutions that pose systemic risks.[1]

We have begun to see balanced scorecards appear in bank remuneration schemes that call for improvements in risk management and bank credit quality as key performance indicators. While this is positive and a welcome step forward, it is even more important that remuneration schemes provide incentives for banks to avoid material deterioration of credit quality – a focus on the downside, not the upside. This is obviously a concern of creditors, but a concern also shared by shareholders, particularly in the case of banks, where funding costs and funding stability are critical to the long-term sustainability and value creation of the enterprise.

Credit quality as a binding constraint for bonus payouts

F&C plans to engage in dialogue with major banks with the goal of establishing a minimum standard of credit quality as a bonus underpin – or precondition – of bonus awards. As a first step, our intention would be to encourage banks to clearly define a base level of acceptable credit quality and how this is best measured. If these credit quality standards are met as well, then bonus payments could be paid, in accordance with other guiding

1 For example, recent academic paper has encouraged the use of debt instruments as a form of executive remuneration to reinforce a creditor perspective among its executive managers: see "Inside Debt", by Alex Edmunds and Qi Liu, The Wharton School, University of Pennsylvania., Oxford University Press, 2010. In practice, Barclays plc has announced its intention to use contingent capital instruments ("Co-cos") as executive incentive remuneration, as a way both to build its capital base and provide an incentive for responsible bank stewardship.



reo® viewpoint

performance metrics such as economic profit, earnings growth and total shareholder return (TSR). If credit quality standards are not met, then bonus payments would be forfeited even if other performance criteria are satisfied. These incentive criteria would most likely apply to executive management, who are accountable for the health of the bank as a whole, and not to company managers with divisional management responsibility.

Details of measuring credit quality require some thought, but this should be workable and measurable. A non-exhaustive list of possible metrics that could be used either on a standalone basis, or jointly with other metrics, includes the following: credit ratings,[2] credit default swap spreads,[3] the bank's cost of capital, Basel III capital ratios or the level/ growth of non-core liabilities in the bank's funding mix.[4] The threshold for such an underpin could be established sufficiently below the bank's existing credit standing to provide some degree of cushion from minor changes in credit quality, but would be a safeguard against wholesale credit deterioration. It would be important for the credibility of any credit metric to be objective and independent – and not simply reflect the bank's own risk management systems.

Conclusion

Establishing credit quality as an underpin for bonus awards would allow systemically important banks to reward executives for profitability and value creation for shareholders if, and only if, the bank's credit profile is not put at undue risk. While clawbacks/malus already exist for extreme situations, these are "nuclear" deterrents that no one wants to see exercised. By having a credit benchmark as a backstop, we can create an additional layer of protection and incentive for systemically important banks to manage their risks responsibly.

We believe that this form of incentive discipline has economic legitimacy, and would contribute to F&C's support of bank remuneration plans in our voting activity. We also believe that other investors will find merit in the idea, and we continue to advance this concept in the investment community. Moreover, by demonstrating that remuneration systems can help guard against downside risks that threaten systemic stability, the inclusion of credit quality as a bonus underpin should be viewed positively by regulators and other stakeholders, and could even enable banks to defend the granting of bonuses despite the current economic uncertainty.

2 This could relate to the standalone financial strength rating of a bank (e.g. a rating that excludes implicit state support and reflects the contingent liability to the state). While the credibility of credit rating agencies has been under attack for their contribution to the financial crisis, we still believe their ratings could be a useful component of such a performance metric.

3 The idea of using credit default swaps in bank remuneration has been proposed in an academic paper: "Executive Compensation and Risk Taking" by Hamid Mehran, Patrick Bolton and Joel Shapiro; paper presented at Columbia University. Contact: Patrick Bolton at pb2208@columbia.edu.

4 The relationship of non-core liabilities to systemic risk is explored in a recent essay by Hyun Song Shin, Princeton University. "Macroprudential Policies beyond Basel III". Winner of the ICFR-FT Research Prize 2010, published by the International Centre for Financial Regulation.

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reo® viewpoint

Anna Krutikov, Associate Director, Governance and Sustainable Investments January 2011

Focus on: Indigenous Peoples – An Investor Perspective

Who are indigenous peoples?

Indigenous peoples are defined[1] as peoples who are considered to be the descendants of the pre-colonial peoples of the Americas, Australia and New Zealand, as well as marginalised minority ethnic groups in Asia and Africa. Key characteristics of indigenous peoples are:

- strong link to specific territories;
- distinct social, political and economic systems, and distinct language, culture and beliefs;
- origins from non-dominant sectors of society;
- commitment to maintain their distinctive identities.

Shell's oil sands projects in Canada; **Vedanta's** bauxite mine in Orissa, India; **Jindal Steel's** steel plants in Andhra Pradesh, India and **Shell's** biofuel crops in Brazil: these are just some of the projects around the world where exciting development opportunities face concerns associated with the long-standing presence of indigenous people. Characterised by a long history of marginalisation and oppression and a special relationship with the land and its resources, indigenous peoples in many parts of the world have mounted fierce opposition to industrial expansion, forcing companies to recognise their unique needs and rights – or else face reputation damage, delays and even revocation of operating licenses.

An investor perspective

To understand better the unique challenges facing extractive companies operating in areas populated by indigenous groups and the implications for investors, F&C organised a workshop for oil and mining companies, co-hosted by the International Council on Mining & Metals.

The event was attended by representatives of 18 major mining and oil and gas companies as well as several investment institutions, and explored issues such as effective engagement strategies, respecting indigenous peoples' rights, needs in project design and development, sharing of benefits associated with resource extraction, and aligning engagement of indigenous groups with that of wider stakeholder groups, especially host governments.

The discussion identified some key pitfalls and possible solutions that investors should consider when evaluating companies' policies and management systems for engaging with indigenous peoples. Those of greatest interest and relevance to the challenge of interaction with indigenous peoples – are:

- Companies must commit to building a long-term relationship with indigenous groups by accepting a longer timeframe for the project and appointing specialists with expertise in local language, history and culture.
- Companies may also need to demonstrate good faith by investing up-front in the development of the community dialogue and negotiation skills. While this may meet with internal resistance, such a strategy will help the company avoid later accusations of exploiting an ignorant or badly-educated population.
- Companies should take into account local cultural specificities in determining how best to meet the community's needs, which may dictate how, in what form and to whom compensation is paid, what development projects receive community support, and what steps are taken to ensure that those consulted reflect the genuine needs of the entire community.
- Companies should ensure that local indigenous groups are not marginalised or disadvantaged due to lack of education or other historical factors. To achieve this, companies may wish to consult the community regarding preferred areas of employment and training.
- Companies need to identify credible partners to work with host governments To avoid taking on the role of a quasi-government in the region. Through these partnerships, they will be able to champion the needs of local indigenous groups and support programmes aimed at improving their welfare.

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1 International Council on Mining & Metals, Good Practice Guide: Indigenous Peoples and Mining, October 2010

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Next steps

F&C will continue to engage extractive companies that seek access to resources in areas populated by indigenous communities, as well as companies in other sectors that may be affected by this issue. In particular, we will look to companies to demonstrate the following:

- A clear group-wide policy addressing the significance of indigenous peoples and implications for the business in the context of the evolving international legal and best-practice context;
- Evidence of identification of indigenous peoples in the areas where the company is currently operating or planning to enter in the future, as well as recognition of their rights and needs, and policies for engaging with them;
- Development of systems for engaging with indigenous communities to secure consent to the project and maintain ongoing dialogue that address the challenges identified in this report;
- Investment in trained, qualified experts, both for initial mapping of the needs of indigenous peoples, and for ongoing engagement;
- Reporting on engaging with indigenous peoples, which includes information about the systems and frameworks for dialogue – as well as its success or failure.

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Alexis Krajeski, Director, Governance and Sustainable Investments

F&C backs call for Australian oil producer to price carbon

Australian oil and gas producer Woodside Petroleum Limited was the subject of a shareholder proposal today filed by a group of 109 Australian institutions urging it to publish a Carbon Price Assumption Report. F&C has voted in favour of this proposal, which comes at a time when fellow oil and gas companies including ExxonMobil, Royal Dutch-Shell, BP, Total and Statoil have disclosed the carbon price assumption they factor into all capital expenditure modelling. Moreover, Australian competitor Santos has disclosed some information about sensitivity testing across a range of carbon prices. As the Australian government debates whether or not to proceed with policies that will place constraints on carbon emissions, F&C considers it essential for large CO_2 emitters like Woodside to ensure their business model is resilient in the face of potential escalation in the carbon price. Although Woodside has disclosed a clear climate change strategy and significant data on its overall emissions, the absence of any carbon price assumptions means investors have no clarity over how these data are relevant to core business decision-making. We also note that the company has not disclosed a target to reduce greenhouse gas emissions or improve the carbon intensity of its operations. In light of the increasing possibility of carbon regulation in Australia, we urge the company to move forward and disclose a clear path to lower carbon growth that is 'cooked in' to the economics of the business.

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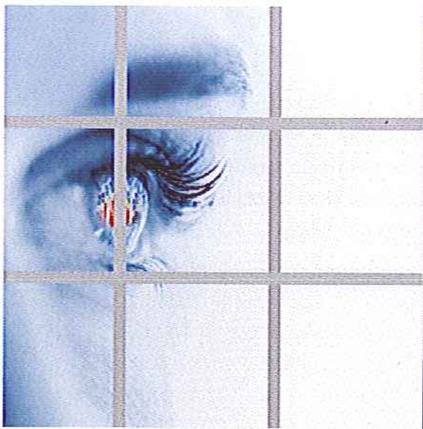

reo® viewpoint

Eugenia Unanyants-Jackson, Senior Analyst, Governance & Sustainable Investment

Russia's bold play... and own goal

Russia's pervasive corruption, weak rule of law and intensive state meddling in business once again dominated the headlines this month, as President Medvedev decried his government's failure to create an attractive investment climate and announced bold new reforms. But these were promptly upstaged by the FSB, Russia's security agency, as it moved to crush the country's leading anti-corruption campaigner, whose popular whistleblowing website and blog are proving a thorn in the side of Russia's 'crony capitalists'.

Facts in the News

- Russia's Central Bank has reported a net $21bn of capital outflows in the first quarter of 2011– a startling 62% year-on-year rise, despite favourable economic conditions and rising oil and commodities prices.
- Russia has been ranked 154th out of 178 on Transparency International's Corruption Perception Index, alongside Cambodia, Kenya, and Tajikistan and significantly below other BRICK countries.

They said

"Some kind of enduring reform of the financial and judicial system is needed because currently the rate of capital outflow is unsustainable."

Chris Barter, Co-Chief Executive, Goldman Sachs Russia, *Financial Times*, 5 May 2011[1].

Capital outflows prompt bold steps by Medvedev

In response to spiralling capital outflows, President Dmitry Medvedev surprised Russia watchers by announcing a number of bold moves, including:

- Ordering a clear timetable for privatising state holdings in Russian companies over the next three years
- Increasing transparency of capital expenditure and procurement by state-controlled companies to reduce corruption and raise returns
- Removing high-ranking government officials from the boards of state-controlled companies
- Enhancing minority shareholder rights and access to company information through changes in law and regulatory practices
- Increasing transparency of investigations into corruption allegations against government employees

This comes on top of recent amendments to the Russian Securities Markets Law that brought beneficial ownership disclosure requirements in line with the European Transparency Directive. Medvedev has also called for all Russian companies to move to International Accounting Standards (IAS), a welcome development – provided companies respond – as Russian accounting standards differ significantly from IAS and create needless confusion as well as opportunities for abuse.

F&C has long pressed for decisive reforms to Russian policy and regulation, including through formal submissions to regulators, meetings with government officials and one-to-one engagement with board members of state-controlled companies.[2] Curbing corruption, strengthening the rule of law and reforming governance are all essential steps that, together with reducing state involvement in business, would lower the risks associated with investing in Russia. However, Medvedev's earlier efforts to drive reform have been suffocated by systematic interference in the judicial process and pervasive corruption of the state bureaucracy. But could this time be different? As questions emerge about Medvedev's willingness to allow Prime Minister Putin to stitch up the next presidential election, will reform serve as the political battleground in a genuinely competitive run for the top office – or will Russia resume business as usual? As change sweeps across the Arab world and stirs up rumblings of dissent as far as China, Russia stands at a new crossroads: could growing use of the internet to expose corruption, combined with pressure from soaring capital outflows, conspire to lend momentum to true reform where past efforts have run aground?

Medvedev surprises with purge of state-controlled company boards

Medvedev's 'purge' of state-controlled company boards raises potentially interesting questions about the future direction of Russian governance. In an environment where government representatives account for the majority of board members at state-controlled companies, questions have long been raised about state interference in the strategy of these companies, and the impact this has both on financial performance and minority shareholder interests. As the 2011 peak Russian voting season shifts into high gear, all eyes will be on the ballots, to see whether Medvedev's edict will be carried out.

So far, 17 companies, including such giants as Gazprom, Rosneft, VTB, Sberbank and Aeroflot, have been served notice that state appointees must exit by July 1st, with another 1,000+ companies facing a deadline of

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1 "Medvedev expected to target capital flight", *Financial Times*, 5 May 2011

2 F&C participated in the consultation leading to the release of the Federal Markets Securities Regulator's Corporate Governance Code (December 2001), and met with government officials in January 2009, including sharing a panel at an investment conference organised by Russian investment bank Troika Dialog.

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October 1st 2011. Igor Sechin, Deputy Prime-minister with oversight for oil & gas, and Alexei Kudrin, Finance Minister, and respectively chairmen of oil and banking giants Rosneft and VTB, have already relinquished their seats, leaving a power vacuum and prompting speculation about what will follow. Igor Levitin, Chairman of Aeroflot and Minister for Transport, will also step down in June. With peak AGM activity occurring in June/July, further announcements are expected and will serve to make this Russian voting season one of the most closely watched ever.

Reading the tea leaves: What do these changes portend?

While clearing ministers off of boards is an important first step, the real test will come from what follows: will the government really be prepared to loosen the reins and leave strategic and operational decisions in the hands of professional managers? Medvedev has urged that the new replacements be 'professional, unbiased, non-corrupt' and have a 'good reputation in the market'.[3] However, the government has since clarified that outgoing state appointees will be replaced by 'professional trustees' rather than independent directors, and it appears that it has already drawn up a list of replacement candidates for the first 17 'priority' companies. Whether these professional trustees will have to follow government instructions for all board decisions or be granted a degree of discretion is unclear. Therein lies the question, but for now, it appears that the government is not yet prepared to cut the strings with Russia's largest companies.

Yet over time, Medvedev's boardroom shake-up could be a great opportunity for Russian companies to improve their competitiveness and returns. It offers a chance for them to staff their boards with experienced professionals who can add value to the business and protect the interests of minority investors and other stakeholders. To achieve this, companies should actively engage with the government and make the business case for reform, rather than slavishly waiting for the 'decision from the top'. Investors need to have confidence that these new directors, even if initially drawn from the pool of professional trustees, are well equipped for the role. This is the message that F&C is communicating to its Russian holdings over this voting season through its dialogue and voting, which will cover companies including Gazprom, Rosneft, Sberbank, VTB, Surgutneftegas, Kamaz and Rostelecom, to name just a few.

A fly in the ointment

Regaining investor confidence will inevitably be an uphill battle in Russia in the wake of such high-profile cases as the Yukos expropriation,[4] the recurrent TNK-BP battles[5] and the near-destruction of Hermitage Capital and alleged murder of its lawyer, Sergei Magnitsky.

> Sergei Magnitsky was arrested and died in custody in 2009 after blowing the whistle on corrupt state officials while conducting an investigation for the activist British investment fund Hermitage Capital. Recently-leaked details of the official inquiry into his death suggest that charges against Magnitsky had been fabricated.[6]

But Medvedev's reforms have been further overshadowed by reports of a crackdown by Russia's formidable Federal Security Service (FSB) on Alexei Navalny, a prominent anti-corruption campaigner who has used his popular internet blog to shine a spotlight on corruption, fraud, nepotism and financial irregularities in Russia's government and top state-controlled companies.

Media reports have revealed that the FSB forced Yandex, Russia's top Internet portal soon to list on Nasdaq, to turn over private financial details about Navalny and his contributors.[7] His supporters also received threatening phone calls from the authorities in an apparent effort to starve Navalny of further funding. As F&C went to press, reports had emerged that Russian prosecutors had launched a formal criminal investigation against Navalny.[8]

So while change is afoot, it will not come without a fight: as this incident reveals, people in the top echelons of power are as determined as ever to keep control, and are prepared to use the judicial and security apparatus to secure their interests, curtail freedom of speech and suppress anti-corruption efforts. Unsurprisingly, Yandex's listing prospectus warns of political risks associated with efforts by the state and various business interests to control Russian media companies.[9] Investors – not only in this internet company but in Russian companies generally – should heed this warning: as long as this persists, and until Medvedev can gain the upper hand over those who continue to thwart his reforms, Russian securities will trade at a hefty discount.

They said

"...the damage to the country's image is exacerbated by the conflicting signals given by its leadership. President Medvedev, an active Internet user, emphasises Internet freedom as part of his personal credo. This is vital for Russia's investment climate as well as its politics."

Reuters Breakingviews, 11 May 2011[10]

3 Statement by President Medvedev, 22 April 2011 Government meeting on economic issues, as reported on http://eng.kremlin.ru/transcripts/2122
4 In 2003, the Russian government opened an investigation for tax fraud against Mikhail Khodorkovsky, founder and Chief Executive of publicly-listed Yukos, ultimately resulting in the expropriation of the company valued at $39 billion, the imprisonment of its CEO, and the relisting of these assets under the reconstituted state-owned oil company Rosneft.
5 The TNK-BP joint venture, a 50/50 partnership between British oil giant BP and Alfa-Access-Renova group of Russia, has experienced a series of conflicts including litigation due to disagreements over the strategy and governance of the company.
6 "Magnitsky case police officials seek London arrest", *Independent*, 3 May 2011
7 "Yandex divulges info on Russian anti-corruption crusader", *AFP*, 2 May 2011
8 "Web fears grow as Russia targets anti-graft blogger", *Financial Times*, 11 May 2011
9 *AFP*, Op Cit
10 "Warning Signal", *Reuters Breakingviews*, 11 May 2011

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