reo® viewpoint

Engagement Activity Report Q2 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:

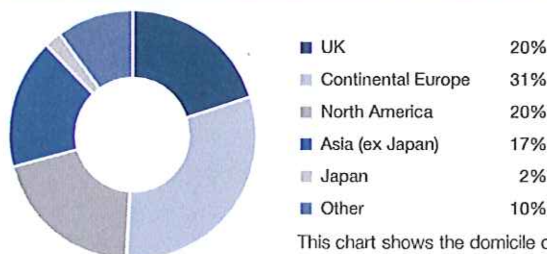
- A 18-person team of Governance & Sustainable Investment specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary
- Global engagement across all markets
- 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	166
Business Ethics	109
Sustainability Management & Reporting	134
Environmental Management	56
Ecosystem Services	26
Climate Change	99
Labour Standards	53
Human Rights	96
Public Health	24

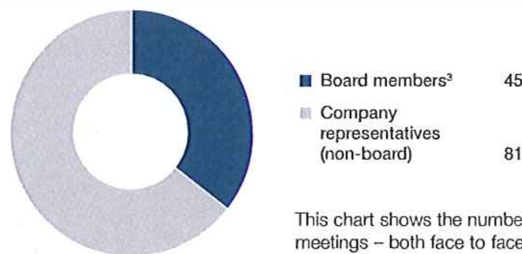
Total number of companies engaged[1] this quarter	335
Number of countries	42
Company meetings voted[2]	3,334

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. This period covers 1st March to 31st May 2011.
[3] Includes Named Executive Directors in the US.

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F&C Investments

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George Dallas, Director, Corporate Governance

May 2011

"Creeping takeovers" in Germany: A fitting end to an unacceptable practice

Background

In October 2008, the financial markets were rocked by the share price of Volkswagen AG shooting up by almost 150% over a two-day period, making it – for a brief time – the world's most highly-valued German company. But the reason for this skyrocketing capitalisation had nothing to do with Volkswagen's intrinsic value; it had everything to do to with severe market distortions in the company's share price caused by large undisclosed derivatives purchases – known as a "creeping takeover" – that had enabled German automaker Porsche AG to build a 74% stake in its German rival.

This obscure and very technical form of trading had already sparked investor outrage only months earlier, when the small family-owned Schaeffler Group used a similar approach to attempt a daring takeover of German tyremaker Continental AG. Such stealth practices were widely regarded as market abuse outside of Germany, but cast an awkward spotlight on a loophole that was tolerated under German law. By making these large derivatives purchases on the sly, Porsche and Continental had accumulated large stakes in their targets without minority investors knowing of their intentions, thereby depriving them of their right to cash in on the premium in value that ought to have accrued to them.

F&C protested vehemently, including through direct contact with BaFin, the German regulatory authority – but to no avail. However, following persistent engagement, including through joint investor action, reason finally prevailed, and in April 2011 the practice of creeping takeovers was finally abolished by the German Parliament, marking a successful, if overdue, conclusion to this two-and-a-half-year effort to drive public policy reform.

Taking its message to the top: F&C engages the regulator

When confronted with corporate behaviour that is unacceptable to minority shareholders but sanctioned by law, there is little that investors can do to persuade a company voluntarily to refrain, particularly when the stakes are so high. Following both Schaeffler's bid for Continental and Porsche's bid for Volkswagen, F&C responded by protesting directly to the German regulatory authority Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), copying the chairmen of the bidding companies and Mr. Gerhard Cromme, head of the German corporate governance commission.[2] In our letters, we emphasised our objection to this cynical manipulation of the law, which we charged was being observed in letter but breached in spirit, and warned the regulator of the damaging impact such behavior was having on the credibility of both German corporate governance and the regulatory framework that underpinned it.

What is a "creeping takeover"?

A creeping takeover is a practice that enables the use of a type of derivative contract – cash-settled options – as a means for hostile bidders secretly to secure a significant stake in the target company without making public disclosures. German laws relating to takeovers and traditional disclosures normally require that an investor disclose an equity position of 3% of a company's voting shares. However, using this obscure loophole of a cash-settled option, an investor could secure substantive economic control of a target company without triggering disclosure obligations.[1] Thus, in mid-2008, Schaeffler Group used this technique to acquire a 36% stake in Continental AG – although the transaction subsequently failed, plunging it into crisis within a year. No sooner had Schaeffler launched its bid than Porsche followed suit, amassing a 74% stake in Volkswagen that succeeded in securing control of its rival and forcing a merger that resulted in Porsche having to assume unsustainable amounts of debt to finance the transaction. Ultimately, the tides turned and Volkswagen subsequently assumed control of Porsche.

Why is this bad for investors?

Disclosure of significant ownership stakes is widely regarded as a fundamental right of shareholders, particularly when a bidding company wishes to achieve a controlling or majority stake in a company. In such situations, it is typically the case that the share price of the target company increases, often significantly, as a form of "control premium" – reflecting the value to the bidder of taking a controlling economic stake.

However, when the accumulation of the economic stake is not disclosed, as in the case of a creeping takeover, minority shareholders of the target company lose their stake in the company, without benefitting from the higher share price. In effect, this is a transfer of wealth from minority shareholders to the bidding company – and insofar as it is done without their knowledge or consent, can be viewed as illegitimate. Moreover, this approach allows the stealth bidder to achieve a controlling or majority stake in a company without providing existing minority shareholders with a comprehensive understanding of the operational and financial strategy underpinning this takeover. Indeed, the results of these takeovers ultimately had ill effects on the financial health of the bidders, both Schaeffler and Porsche.

1 As explained by Eduardo Gallardo of the law firm Gibson, Dunn & Crutcher LLP, cash-settled options do not confer upon the holder the right to acquire shares, but only the right to claim a cash settlement. However in economic terms this claim to a cash settlement is tantamount to the acquisition of economic control. See the Harvard Law School Forum on Corporate Governance and Financial Regulation, 1 March 2011: *http://blogs.law.harvard.edu/corpgov/2011/03/01/germany-to-ban-stealth-takeover-strategies/*

2 See F&C's letter to the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) on Continental AG/Schaeffler Group in August 2008: *http://www.fandc.com/FundNets_FileLibrary/File/Conti%20Schaeffer_FINAL.pdf* and F&C's letter to BaFin on VW AG/Porsche AG in October 2008: *http://www.fundnets.net/fn_filelibrary//file/Letter%20to%20BaFin%20about%20German%20disclosure%20requirements%20relating%20to%20Porsche%20AG's%20stake%20in%20Volkswagen%20AG.pdf*

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We also emphasised to BaFin that the "creeping takeover" loophole was at odds with takeover and disclosures legislation in other developed market jurisdictions, stressing that the transparent disclosure of direct or indirect ownership positions was a critical consideration for minority investors. F&C specifically encouraged BaFin to launch a review of disclosure thresholds in Germany, to encompass both direct economic stakes as well as indirect stakes through equity swaps or other forms of derivative contracts.

In parallel, F&C used its voting rights to express its concerns about the practice of creeping takeovers to the companies involved with this practice. Though not a shareholder of the Schaeffler Group or Porsche, F&C did hold stakes in both Continental and Volkswagen. Accordingly, F&C did not support the ratification of the supervisory boards at Continental and Volkswagen in voting at their annual general meetings of 2009, noting that their supervisory boards included representatives of Schaeffler and Porsche, respectively. These votes were followed up with letters to the chairmen of Continental and Volkswagen, where F&C explained its concerns and voting rationale in greater detail.

The regulatory response: if at first you don't succeed...

F&C's letter to BaFin in August 2008 protesting the Schaeffler bid met with an efficient but lukewarm response: the only way to abolish creeping takeovers would be to change the law, but BaFin left little room for optimism about the desire of German legislative bodies to act on F&C's intervention. Faced with this disappointing response, we upped the ante by joining with other investors in late 2008, writing to the German Federal Minister of Finance and the chairman of the finance committee of the German Parliament to press the case for reform directly with elected leaders.

Happily, in February 2011, the lower chamber German Parliament (Bundestag) was convinced of the merits of our argument, and approved a new bill to close the legal loophole that had allowed for creeping takeovers.[3] On 18th March, almost three years after the infamous Conti-Schaeffler raid and the wave of investor outreach that it triggered, the bill was passed by the second chamber of German Parliament (Bundesrat), and then signed into law by the German President in April 2011.[4]

This change of legislation places German takeover law on a level playing field with other jurisdictions. It is a victory for minority shareholders, both inside and outside of Germany, and a positive step forward for German corporate governance. Most of all, it demonstrates that when practices are unacceptable, it is possible for investors to take constructive action to drive positive change.

We said...

"We would like to reassert our strong reservations about how substantial positions in German firms can be established using financial instruments that avoid public disclosure. This may meet the letter of the German law, but we do not believe this reflects the proper spirit of good corporate governance, where transparency and disclosure of direct or indirect ownership positions are critical considerations for the protection of minority investors."

F&C letter to BaFin, 29 October 2008, in response to the Porsche/ Volkswagen transaction.

They said...

"Please keep in mind that it is up to the legislator to check the necessity to change the laws, especially the domestic transparency provisions... however it is very likely that in this process the legislator could consider the current and future regulation in the UK as well as your friendly and constructive contribution."

BaFin letter to F&C on 16 September 2008, following receipt of F&C's earlier letter on the Schaeffler/Continental transaction.

3 This was approved as part of the "Investor Protection and Capital Markets Improvement Act" (Anlegerschutz- und Funktionsverbesserungsgesetz).

4 Specifically, investors holding financial instruments, including cash-settled options, must now disclose these to BaFin when they amount to 3% of a company's equity capital. In the event of abuse there is a potential sanction that could reach €1 million.

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Sagarika Chatterjee, Associate Director, Governance & Sustainable Investment

Hungry Planet: Food security, 9 billion people and the companies that feed them

Food security[1] and climate change: Why it matters

- **Food producers face a perfect storm: they must drastically boost food output amidst diminishing resources.** Over the next 40 years, the global population will rise by one-third to 9 billion, with most of that growth primarily in emerging markets[2]. Accelerating economic growth in these markets, combined with rapid urbanisation, means that 70% of these consumers will live in cities, demand more meat, dairy and processed foods, and depend on better food distribution. At the same time, however, changing climate and higher oil prices are interfering with farmers' ability to meet this growing demand, as an increase of 1˚C above optimal weather during growing season means a 10% reduction in crops[3]. Food shortages and high prices[4] raise the risk of public unrest and, in extreme cases, mass migration[5] – and have already contributed to riots in Maldives and political upheaval in Tunisia and Egypt. The drivers behind global food security problems are complex: they include rapid economic development and changing consumer lifestyles; under-investment in agricultural productivity and food distribution; limited arable land suitable for growing crops in high demand[6]; diversion of food crops to biofuels production[7]; a secular rise in food prices associated with a high oil price; and increased volatility due to poor harvests, overheated commodities markets and ill-judged national policies, such as price and export controls.

- **Faced with galloping demand, food and beverages companies must secure supply by weather-proofing supply chains as much as possible.** Unpredictable weather has always been a feature of agricultural production, but with the added pressure of booming urban populations ready to take to the streets, governments have resorted to expedient actions to protect food supplies, thereby exacerbating disruptions to companies' sourcing of commodities. The Indian government just lifted its ban on onion exports, imposed to quell public protests at soaring prices caused by rain-soaked onion crops. In 2010, the Russian government banned grain exports after droughts devastated wheat crops, triggering turmoil in global commodity markets. In response, the Chinese government has undertaken drought relief actions to protect grain production, while Australia, still reeling from ruined wheat and sugarcane crops after severe flooding, has yet to define a clear adaptation policy. As average temperatures creep upward, climate change will likely exacerbate volatility in weather, prices and government interventions, impacting companies' sourcing of certain commodities. For food and beverage companies, a strong understanding of these risks is important to ensure security of supply of key ingredients.

- **Are companies ready for a changing climate?** For over ten years, F&C has engaged with food and beverage companies to encourage reduction in greenhouse gas emissions. While enormous challenges remain in the agricultural supply chain[8], most major global companies have now developed robust approaches to minimising emissions from food processing. But with uncertainty about a global post-Kyoto deal stalling efforts to drive down emissions further, and global temperatures rising steadily, F&C has turned its attention to:
  1. Understanding how the inevitable change in the climate will affect feedstock supplies, and
  2. How well positioned global food and beverage companies are to adapt to climate change.

Findings from F&C's dialogue with companies

Our intensive dialogue has included Ambev, Asahi Breweries Group, Groupe Danone, Heineken, Kraft, Nestlé, PepsiCo, SABMiller and Unilever. We have also engaged with Monsanto, BASF and Norwegian fertiliser company Yara. Our key findings are that:

1. Climate change poses significant risks to food and beverage supply chains:

Danone, PepsiCo, Nestlé, SABMiller and Unilever consider that the physical impacts of climate change present significant future risks to their business,

1 Food security means people have access to sufficient, safe, nutritious food to maintain a healthy and active life. It comprises food availability - sufficient quantities of food available on a consistent basis; food access - having sufficient resources to obtain appropriate foods for a nutritious diet; and food use - appropriate use based on knowledge of basic nutrition and care, as well as adequate water and sanitation. Source: http://www.who.int
2 World Economic Forum, *Realizing a New Vision for Agriculture*, 2011
3 Lobell et al, 'Climate trends and global crop production since 1980', *Science*, 5 May 2011
4 The UN's Food and Agricultural Organization's Food Price Index measures the wholesale price of basic foods within a basket. It averaged 231 points in January 2011, which is its highest level since records began in 1990. Source: http://www.fao.org/
5 UK Government Office for Science, *The Future of Food and Farming*, 2011
6 UN FAO, *How to Feed the World in 2050*, 2009
7 Ibid
8 Emissions from crops and animal husbandry are forecast to rise even in the most ambitious climate planning scenarios – see European Commission 2050 Road Map http://ec.europa.eu/clima/documentation/roadmap/docs/com_2011_112_en.pdf

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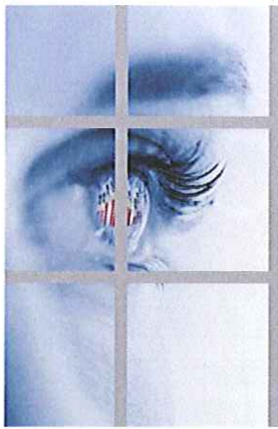

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primarily in relation to security of supply[9], unlike Kraft, which dismisses this view[10]. So far, although companies are finding they must respond to fluctuating commodity prices, they do not attribute any impact on overall costs or availability of key commodities to climate change per se. However, companies expect that over a 6-15 year horizon, this balance will change as certain commodities become increasingly vulnerable to climate change. Key future risks to security of supply include:

- **Declining yields and raw materials shortages:** PepsiCo, for example, considers that essential commodities could become less available, including sugar, corn, wheat, rice, oats, potatoes and fruit. Nestlé estimates that in the next 6-10 years, commodity prices will increase due to yield declines, and that in the next 0-5 years, even minimal global warming could harm the quality of its coffee and cocoa, with extreme drought hampering irrigation. Faced with these trends, producers could convert land from coffee and cocoa production to meet local food security needs, decide to diversify their crop ranges or switch to drought-resistant crops.
- **Water stress:** Danone, PepsiCo, Nestlé, Unilever all have supply chain initiatives underway to manage water, including robust risk assessment, targets to reduce usage and engagement with fellow watershed users. Heineken and SABMiller believe that climate change could impact water needed both to grow crops and to brew beer, and have prioritised managing locations at risk of water stress. Nestlé cites water stress as the single-greatest physical risk climate change poses to its supply chain; irrigated and rain-fed coffee plantations could experience productivity disruptions from volatile rainfall and regional water stress, with lack of precipitation already affecting certain sites.

2. How can food and beverages companies adapt to climate change?

Companies are still in the early stages of adapting to climate change, with supply chain efforts to date having focused more on reducing emissions. None of the companies F&C spoke with have fully embedded the need to adapt to climate change within their business strategies. Encouragingly though, good practice is under development. Thus, leading companies have begun to:

- **Assess supply chain risks:** This is an essential first step for companies to understand how climate change will impact key food and beverages products. Unilever has developed a web-based tool enabling suppliers to map and report back on water and food security risks. Similarly, Nestlé has developed a database that captures supply chain exposure to floods and natural hazards. Nestlé has asked suppliers to identify and report on physical risks from climate change through the Carbon Disclosure Project Supply Chain Project. It has benchmarked its 150 key suppliers based on their responses, and buyers will engage with suppliers to mitigate climate change-related risks in 2011/12.
- **Boost agricultural productivity:** While historically, rises in demand have been met by expanding areas under cultivation, this option is becoming less attractive, as much of unused arable land is unsuitable, either due to its environmental characteristics or to its location in remote areas with weak infrastructure[11]. A more feasible option therefore is for companies to increase productivity, through research into higher-yielding seeds and better training of farmers in their supply chains.

  Agricultural research can improve soil nutrition, reduce use of fertilisers and better protect crops from weeds, insects and disease. Nestlé's Cocoa Plan, for example, involves a CHF 110 million investment in plant science and sustainable cocoa production in Côte d'Ivoire and Ecuador. This plant research aims to improve cocoa quality and quantity, and 600,000 plants will be produced in 2011.

  Where companies source directly from farmers, training can improve agricultural practices. Unilever has issued guidelines on sustainable agricultural practice for suppliers of key crops, aimed at ensuring farmers are better equipped to respond to a changing climate. PepsiCo is piloting low-water farming techniques in Florida and Egypt, including using less ammonia-based fertiliser and less water per hectare. SABMiller has encouraged farmers to grow crops that are more tolerant of changing climatic conditions, like sorghum, so these can supplement traditional feedstocks like barley, or replace them to make new beer products.

9 Based on Carbon Disclosure Project responses by companies.
10 Kraft has stated that this risk rating is following its review of SEC reporting obligations and legal guidance on the Carbon Disclosure Project (Source: Kraft CDP response).
11 UN FAO, *How to Feed the World in 2050*, 2009, and Nestle, *Creating Shared Value and Rural Development Summary Report*, 2010.

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- **Leverage carbon market opportunities:** At this stage, company initiatives to take advantage of the carbon market remain extremely limited and largely confined to philanthropically-funded pilot projects. Danone, for example, is working with the IUCN to restore mangroves in the Sundarbuns in India with a view to protecting local infrastructure and crops from hurricane and flood damage. Over 2011, villagers will plant 2,000 hectares of mangrove trees, generating carbon credits through the voluntary carbon market. While F&C welcomes early innovation that assists local communities in adapting to climate change, we encourage companies like Danone to consider how the findings from such pilot projects can be integrated into their broader climate change strategies and management of security of supply of raw materials.
- **Take industry-wide action:** F&C is pleased to see the launch of a new business initiative on food security, The World Economic Forum Sustainable Agriculture Initiative. This will address food security by promoting industry good practice in nutrition, agricultural productivity and rural economic development. On agricultural productivity, endorsing companies have committed to good practice in water use, soil health and biodiversity conservation. To date, companies with which F&C has engaged and that have endorsed the initiative include Unilever, Nestlé, Yara, Syngenta and BASF.

3. Where is more action needed?

- **Companies involved in crop science:** Genetically-modified (GM) seed and agrochemicals hold great potential to bolster productivity by providing better crop resistance to drought and plant disease, as well as better weed management. However, serious concerns remain about the impact of over-use of agrochemicals on soil health and water tables, while public concerns surrounding the potential effects of GM crops on biodiversity, arising from herbicide-resistant "super weeds" and contamination of non-GM crops, have yet to fade. F&C has encouraged Yara, Monsanto and BASF to implement strong controls to protect soil quality, and to avoid contamination of water, land and species. We have recommended that companies factor biodiversity into crop science, product development and farmer education. We are pleased to see some progress; BASF and Yara have endorsed the new World Economic Forum Sustainable Agriculture Initiative, committing to tackling food security by improving rural livelihoods, water use, soil health and biodiversity.
- **Challenges remain for GM seed manufacturers;** after over a decade of controversy, they have yet to respond effectively to allegations that they harm farmers' incomes by locking them into buying new GM seeds each year, rather than saving some from the previous year's harvest, and that seed patents bring higher costs and reduce farmers' choice in seeds. To date, few companies have demonstrated how they can reconcile high-level pledges to boost rural economic growth with these key aspects of their basic product design. F&C's view is that while it is unlikely that any single technology is a "silver bullet" to resolve productivity challenges, the crop science industry must develop an effective response to such concerns if it is to win broad-based support for GM technology as a significant contributor to ensuring food security.
- **Business-government action:** Companies told F&C that on the whole, governments had under-developed action plans for climate change-related risks to food security. Although governments react quickly to shocks such as severe drought, they are poor at responding to "slow-burning" stresses. Governments encourage companies to broadly contribute to rural economic growth, but few, if any, have specifically asked companies to assist in adapting to climate change. Despite the lack of government leadership, Nestlé and Unilever will encourage suppliers and farmers to adapt to climate change. They anticipate that changing weather patterns will impact agricultural productivity and rural incomes, which could in turn affect rural consumers' purchasing power and therefore product sales. F&C's welcomes such business leadership on climate change, but for maximum impact, scientists, governments and companies must work more closely together to understand and respond to risks to food security from climate change.

F&C assessment and next steps

Companies that take action now to adapt their supply chains to climate change will be better-positioned to withstand government policies aimed at securing food supplies and give consumers the food and beverages products they want while avoiding extreme price volatility. This is essential to meeting

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global food security challenges, securing long-term growth and ultimately maintaining political and social stability. Good practice is starting to emerge, but companies must accelerate action in the following areas to protect supply chains from declining yields, raw materials shortages and water stress:

- Factor physical risks from climate change into food security and sourcing strategy, and ensure this enjoys the full understanding and support of the board;
- Invest in agricultural productivity improvements for key crops, working alongside agricultural specialists, suppliers and farmers; and
- Work hand-in-hand with governments on effective local response to food security, encouraging strong joined-up action on adaptation to climate change.

In addition to intensive engagement with companies on the above areas, F&C will support collaborative investor initiatives including the Institutional Investors' Group on Climate Change, CDP Water Disclosure and UN CEO Water Mandate.

They Said...

"Even if the onion price spike is short-lived, it is a bitter reminder of India's challenge in agriculture, where growth in output is trailing far behind rising demand for food, leading to a steady upward pressure on prices."

– "Onion crisis adds to Indian PM's woes" *Financial Times*, December 22 2010

"The case for urgent action in the global food system is now compelling. We are at a unique moment in history as diverse factors converge to affect the demand, production and distribution of food over the next 20 to 40 years. The needs of a growing world population will need to be satisfied as critical resources such as water, energy and land become increasingly scarce."

Professor Sir John Beddington, Chief Scientific Adviser to HM Government, and Head of the Government Office for Science, UK Government Office for Science, *The Future of Food and Farming*, 2011

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Juan Salazar, Analyst, Governance and Sustainable Investments June 2011

The Ruggie Principles: A Turning Point for Business and Human Rights

In January 2011, amidst the early stirrings of the 'Arab Spring', telecommunication companies **Vodafone** and **France Télécom** were instructed by the Egyptian government to shut down mobile and internet services across the country. Next door in Libya, government forces allegedly bombed civilians with cluster munitions made by customers of major European banks, including **BBVA**, **Santander** and **Deutsche Bank**. And governments across the Arab region turned to technology supplied by American IT companies such as **Intel** to filter internet content and block websites.

As reports of violence across the Arab world dominate global news, companies increasingly face difficult questions about the extent to which their continued presence in these volatile countries contributes to, enables, or in some way legitimises the abuses that are occurring. While neither new nor confined to the Arab region, these questions have long gone unanswered, as companies and civil society have struggled to determine who bears responsibility for preventing or remedying human rights abuses when the very state whose job it is to prevent them is in fact the perpetrator.

But is it the role of business enterprises to prevent human rights abuses? For Professor John Ruggie, Special Representative to the UN Secretary-General on Business and Human Rights, the answer is unambiguously Yes.

A six-year journey

Professor Ruggie's work began in 2005, when then-UN Secretary-General Kofi Annan appointed him as Special Representative for Business and Human Rights. His mandate was specifically to explore how far corporate responsibility and accountability extended in the area of human rights, and how to define the respective roles of States and private corporations. The result was the 'Protect, Respect and Remedy' framework, which was unanimously accepted by the member States of the Human Rights Council in June 2008.

The framework rests on three pillars:

- The **state duty to protect** against human rights abuses by third parties, including businesses;
- The **corporate responsibility to respect** human rights, by preventing infringements of the rights of others and addressing adverse impacts should they occur; and
- Greater **access** by victims **to effective** remedy, both judicial and non-judicial.

In order to translate these principles into concrete, practical action by companies, Ruggie in turn developed guidance on their implementation. A three-year, international consultation involving companies (including F&C), States and civil society representatives has resulted in the "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework".

Why do the Guiding Principles matter?

The Principles mark a major turning point insofar as they signal broad-based acceptance of the fundamental principle that business should be responsible for preventing, and therefore actively managing the risks of, human rights abuses linked to their activity. Their development is the product of a comprehensive multi-stakeholder consultation endorsed by the United Nations, and reflect detailed input from a critical mass of influential corporate voices.

Are they practical for business users?

The Guiding Principles seek to articulate the responsibilities of companies with respect to human rights and assist them in their implementation, by:

- Establishing a clear distinction between the responsibilities of States and businesses: while States are bound by international law to protect against human rights abuses, companies are expected to prevent abuses linked to their activity, and address any adverse human rights impacts they cause or to which they contribute.
- Providing companies with practical guidance on how to prevent and address human rights abuses. Specifically, companies should have in place a policy commitment to respect human rights; conduct a human rights due diligence process to identify, assess, manage and account for how they deal with their impacts on human rights; and have mechanisms in place to remediate any adverse impacts they cause or to which they contribute.
- Providing detailed standards by which States can measure and model the judicial and non-judicial remedies they make available for those who suffer business-related human rights abuses.

[1] This guidance document, the result of a lengthy and comprehensive multi-stakeholder consultation process, presents a set of 30 detailed, practical recommendations to help States and companies in the implementation of the Protect, Respect and Remedy framework. The official endorsement of the Guiding Principles by the UN Human Rights Council during its 17th session in June 2011 marked the culmination of Professor Ruggie's mandate.

F&C Investments

Will they get traction?

The UN Human Rights Council's unanimous support for the Guiding Principles represents the first time in the history of the UN that member states endorse a text they had not negotiated themselves. Furthermore, the Principles have already been incorporated into global standards for businesses, such as the OECD Guidelines for Multinational Enterprises , the IFC Performance Standards and the new ISO26000 standard . As these various voluntary initiatives become increasingly accepted and implemented, businesses will benefit from clearer regulation on human rights and thus create a level-playing field.

> **“For the first time ever, you have a convergence of standards and a common, level playing field in the business and human rights sphere, which will send stronger market signals to companies that these are the standards around which expectations and activities should converge. They have the strong backing of the international community, including by business itself.”**
>
> **John Ruggie, 29 April, 2011**

What next?

While Ruggie signals an extraordinary breakthrough, many real challenges remain: firstly, many governments themselves are perpetrators of abuse; and second, the very root of the problem – weak governments and weak institutions – makes it very difficult to enforce robust protection of human rights. What action should a company take if it has a business relationship with a government with a poor record of protecting human rights? This difficult question, increasingly relevant as transnational corporations seek to expand their markets or gain access to key feedstocks in countries with a record of human rights abuses, remains largely unanswered.

Yet despite these limitations, the Guiding Principles represent a major step in the right direction. They enshrine a new common understanding of corporate responsibility, and underscore the importance of strong, proactive management of human rights risks.

F&C Acts

F&C's engagement with companies operating in high-risk countries has long reflected the core belief that robust management of human rights risks is crucial to businesses' long-term success.

Poor management of labour conditions, security and relations with surrounding communities can result in legal, operational and reputational challenges, affecting a company's economic performance. In addition to engaging companies on this subject for over a decade, F&C has participated in the development of key international norms and standards in this area, such as the Guiding Principles themselves and the Guidance on Responsible Business in Conflict-Affected and High-Risk Areas .

Through our human rights engagement programme, we have maintained close dialogue with more than 40 companies that face heightened human rights risks due to either the nature or location of their operations. We have encouraged companies to identify, assess and manage human rights risks at all stages of their operations, and to clearly communicate how impacts are addressed.

Examples of our engagement include:

- Encouraging extractive industry giants such as **Chevron** and **Anglo American** to develop a global human rights policy.
- Encouraging **G4S**, the world's largest private security provider, to develop and implement a robust human rights risk management system.
- Engaging with international mining companies, including **AngloGold Ashanti**, **Antofagasta**, **BHP Billiton** and **Xstrata** to encourage them to assess human rights risks earlier in the exploration process, particularly as they expand into high-risk areas.
- Visiting **Total's** pipeline operations in Burma and gaining an understanding of how best to manage human rights risks along the pipeline corridor. We encouraged the company to share best practice standards with its business partners on the ground.
- Encouraging companies operating in Sudan, including **Petrofac**, **CNPC**, **ONGC** and **Petronas**, to avoid accusations of complicity in human rights abuses by promoting revenue transparency at the government level.
- Discussing with IT companies, including **Cisco**, **Intel**, **Microsoft** and **Yahoo!**, their approach to access, security and privacy concerns across their businesses, especially in markets that control access to information and have weaker privacy and security standards.

[2] These guidelines provide voluntary principles and standards for responsible business conduct in areas such as employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests and taxation. URL: www.oecd.org/daf/investment/guidelines

[3] The IFC Performance Standards outline the International Financial Corporation's guidelines on corporate environmental and social responsibility and form the requirements for receiving and retaining IFC financial support. They cover issues such as labour standards, biodiversity, climate change, business and human rights, supply-chain management, and transparency.

[4] ISO 26000 is an international standard giving guidance on social responsibility. The standard contains voluntary guidance, not requirements, and therefore is not for use as a certification standard like ISO 9001 and ISO 14001.

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In the wake of the Arab Spring:

- We have redoubled our efforts with telecom operators and technology companies, including **Vodafone** and France Télécom, focusing on key areas of good governance and internal controls, including human rights risk management.
- We wrote to 12 companies with operations in Libya, including **ENI, Repsol-YPF** and **Finmeccanica**, to probe how they were addressing the risk of complicity in human rights violations. We asked them to conduct systematic human rights impact assessments upon their return to the country, and examine how any lessons learned from the Libyan case could strengthen their approach to conflict-affected areas more broadly.
- In our dialogue with European and North American banks, including **BBVA, Santander, Deutsche Bank, Credit Suisse, UBS, Bank of America** and **Citigroup**, we have encouraged a more transparent and systematic approach to assessing the reputational risks associated with servicing companies involved in cluster munitions and landmines.

Going forward, F&C's engagement efforts will continue to centre on encouraging companies that face significant human rights-related risks to manage them effectively – drawing now on the universally-recognised Ruggie Framework and Guiding Principles. F&C, for example, co-leads an investor group that is running a pilot project to implement the UNGC-PRI Guidance on Responsible Business in Conflict-Affected and High-Risk Areas. The focus of the project will be on investee mining companies operating in the Katanga province of the Democratic Republic of Congo.

To be continued...

In 2011, the Ruggie Principles have placed human rights at the top of the agenda of companies and civil society. However, Ruggie's work is far from complete. Governments and companies have now the challenging task of implementing the recommendations under the Guiding Principles. To oversee their implementation and dissemination, the Human Rights Council will establish a Working Group consisting of five independent experts (to be appointed at the Council's next session in September 2011) for a period of three years.

In the meantime, and through our dialogue, we will continue to press businesses to ensure they manage risks related to human rights effectively. The hard truth is that, with the challenges posed by a warming world and population growth, political instability and the likelihood of conflict are on the rise. Companies that have identified and assessed the human rights risks they face and have robust systems in place to manage them will be less vulnerable to sudden changes in the political climate and better placed to fulfil their responsibility to respect human rights and protect shareholder value.

[5] This guidance document was developed by the UN Global Compact, the Principles for Responsible Investment and an expert group comprised of company representatives, investors, NGOs and UN representatives. Available at http://www.unglobalcompact.org/docs/issues_doc/Peace_and_Business/Guidance_RB.pdf

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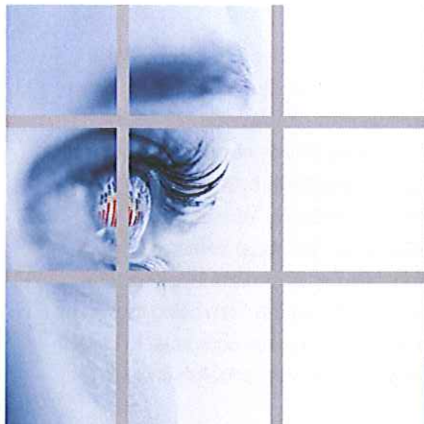

reo® viewpoint

George Dallas, Director, Corporate Governance

June 2011

"Two Cheers" for the UK Bribery Act

Overview: three steps forward, one step back

On 1 July 2011, the long-awaited UK Bribery Act will finally take effect. Passed in April 2010 in the dying days of the UK's last Labour Government, it lays to rest the prior bribery laws which dated back to 1889, and at long last brings the UK into the modern age, 14 years after the country's ratification of the OECD Convention Against Bribery of Foreign Public Officials, and 34 years after the passage of the US Foreign Corrupt Practices Act (FCPA). For investors concerned by the escalating anti-corruption crackdowns and multi-million-dollar fines that have befallen a growing number of blue chip names – Siemens, Halliburton, BAE Systems, Thalès, Alcatel-Lucent, Statoil, HP and Merck– this is good news. Why? How is it that stricter laws, tougher enforcement and higher fines make for better returns for investors? As emerging markets with weaker judicial systems and pervasive corruption attract an ever-larger rush of capital investment, is it realistic to expect Western companies to compete without 'playing by local rules'?

In fact, while bribes may help to win business deals, corruption unquestionably raises operating risk and depresses returns. Investors therefore have much to gain by pressing companies to refrain and enforcement authorities to be consistent and uncompromising in clamping down on it. This is why F&C has, since 2000, led the investor community in calling for stricter anti-corruption standards[1], and played an active role in pressing for the passage of the UK Bribery Act. While slow in coming and fraught with last-ditch efforts to delay and dilute it, including controversial Guidance by the UK Ministry of Justice (MoJ) aimed at diminishing its extraterritorial reach, it marks a historic milestone in the UK's efforts to uphold high standards of corporate governance and use its role at the centre of global finance to drive global efforts to curb corruption

Corruption: why should investors care?

By exacting a large, if hidden, cost on wealth creation, corruption raises investment risks and depresses returns. From vacant 'white elephant' airports to 'bridges to nowhere', to collapsing schools and abandoned hospitals, the scale of waste and embezzlement is estimated to reach over US$1.5 trillion roughly 2.5% of global GDP year after year. By diverting capital away from its "highest and best uses" towards those that offer the richest illicit rewards, corruption not only distorts competition, but breeds corporate cultures that promote circumvention of the law, undermines the rule of law and creates the conditions for companies to mistreat shareholders just as they do other business partners. This is plainly not in the interests of long-term investors and their clients.

The UK Bribery Act: stormy start sparks investor action

The UK Bribery Act is therefore welcome, if long overdue – but its entry into the world was anything but smooth. UK and overseas business lobbies voiced concerns about its broad extraterritorial reach, as well as its deliberate move to lighten the burden of proof needed to secure a conviction by dropping the need for evidence of an actual incident of corruption. Instead, Section 7 of the UK Act establishes a corporate offense of 'failing to prevent bribery', under which companies can face liability if they are judged to have inadequate anti-bribery procedures – so called 'Adequate Procedures'. But by criminalising the bribery of foreign public officials even if none of the malfeasance has occurred on British soil, the Act has now closed the gap with the US FCPA. Indeed, by banning so-called private-to-private bribery, i.e. illicit payments made to non-governmental counterparties in order to win business, as well as facilitation payments[2],it goes considerably further than its American predecessor.

F&C supported the introduction of the Bribery Act, and also led fellow investors in submitting a joint response to the MoJ's Guidance consultation on the Act in the autumn of 2010[3]. However, the implementation of the Act has not been smooth sailing. Faced with a staunch corporate lobby seeking to delay the Act's implementation and water it down, the first few months of 2011 were tumultuous, and resulted in F&C intervening on several occasions to urge passage of the Act without delay and without dilution.

These interventions included a letter in January 2011 from the International Corporate Governance Network (ICGN) – led by F&C in its capacity as Chair of the group's Business Ethics Committee – to the UK Prime Minister's Office objecting to the government's move to delay the introduction of the Act.[4]This proved fruitless as the UK Government pushed back the effective date of the Act to allow additional time for the MoJ to issue Guidance on how it would be enforced.

Then shortly before the Guidance reached its final stages, a leaked report revealed that the MoJ had ceded to pressure from capital markets advocates urging that overseas companies listed on the London Stock Exchange be exempted from the Act's purview, unless they had other connections to the UK. This caused F&C yet again to address the UK Prime Minister's office in protest, posing the following questions:

F&C Investments

[1]F&C authored the International Corporate Governance Network (ICGN) Anti-Corruption Principles issued in 2009 and chairs the ICGN Business Ethics Working Group.
[2]Facilitation payments are defined as small payments made to accelerate the provision of services to which the payor is legitimately entitled, but would otherwise be subject to delay. Unlike outright bribes, they do not seek to obtain or retain business, but do confer a business benefit and an advantage over rivals who choose not to pay them.
[3]See: http://www.fandc.com/FundNets_FileLibrary/file/FC_response_to_Ministry_of_Justice_consultation_on_UK_Bribery_Act_of_2010.pdf
[4]See: http://www.fandc.com/FundNets_FileLibrary/file/ICGN_letter_to_UK_Prime_Minister_regarding_UK_Bribery_Act_January_2011.pdf

- Why is capital-raising in London not regarded as 'carrying out business' in the UK? Surely, capital-raising is integral to doing business?
- Does this not clearly disadvantage honest UK companies that are prohibited from corrupt activity under the Act?
- Does the Ministry of Justice effectively intend that capital raised in the UK markets be used to pay bribes and yet the bribe-paying company go unpunished?

F&C then led a group of fellow UK investors in approaching the Prime Minister's office with a third letter[5], meanwhile also publishing a group investor letter in the Financial Times to express its support for the Act and its concern about the carve-out of overseas issuers on the London Stock Exchange.[6] Finally, F&C appeared on the Today Programme on BBC Radio 4, the UK's top-rated morning current affairs radio programme, to convey this message to the broader British public.

A tarnished guidance?

The MoJ Guidance on the Act was finally published in late March 2011. On the bright side, it steers clear of any further attempt to delay the effective date of the Act, confirming it will come into force in July 2011. The Guidance is also helpful in clarifying how specific features of the Act will and will not be subject to potential prosecution – corporate hospitality being one particularly hotly-debated example.

Disappointingly, however, the Guidance does retain the previously-leaked loophole for overseas firms listed in London if they have no commercial presence in the UK apart from a "mere" listing. Moreover, the Guidance also identifies certain mechanisms relating to joint ventures and supply chains that companies may employ to avoid prosecution under the Act. In effect, this seeks to dilute the Act's original aim of establishing a company's responsibility for actions taken by third parties on its behalf – as has long been the case under the FCPA – by raising doubts about the government's intent. While on balance the introduction of the Act is still an improvement on its predecessor, F&C considers that this last-minute retreat has fundamentally compromised the Act's purpose and effectiveness.

Who will blink first?

Notwithstanding this disappointment, the public visibility that resulted from F&C and fellow investor protests against the overseas issuers' carve-out was not lost on the Serious Fraud Office (SFO) – the body that has responsibility for initiating prosecutions under the Act. Indeed, in response to public concerns expressed about this, Richard Alderman, Director of the SFO warned: "I would say to companies not to rely on very technical arguments that ... you are outside the scope of the act."[7] Perhaps unintentionally echoing Mr. Alderman's point, UK Secretary of State for Justice Kenneth Clarke likewise challenged his critics to take the matter to the courts if they were dissatisfied with the Guidance's interpretation of the Act. This suggests that the one thing that companies value above all else – predictability – will be some time in coming. Between Lord Chancellor Clarke's bravado and Mr. Alderman's tenacity, there is now good reason to expect key aspects of the new Act to be fought over in the courts

Meanwhile, back at the ranch...

Having raised the issue at the highest levels of government and made its point in the media, F&C will now continue to focus on anticorruption as a key component of its day-to-day company engagement outreach. While stricter laws and tougher enforcement can be expected to reduce bribery and corruption in the UK and other jurisdictions globally, the Act imposes much more exacting anticorruption standards on companies, and will force them to raise their game in order to stay aligned with best practice. Failure to adapt could mean not only hefty fines, blacklisting from bidding on contracts and significant reputational damage, but most damagingly of all the prospect of having top management tied up in endless investigations and prosecutions. In sum, corruption is swiftly moving from being the tempting but morally-wrong thing to do to win lucrative contracts, to career and corporate suicide for any company or board that is foolish enough to indulge in it.

Thus far in 2011, F&C has reached out to each company held in reo® client funds to raise awareness of the Bribery Act, encouraging them to address these risks through robust policies, procedures, training and disclosures, and urging clear leadership by the board. This outreach will continue to feature prominently in our engagement agenda as we deliver the message that corruption has no place in companies that we invest in for the long term.

They said...

"It will be up to the court to decide whether or not any individual organisation can be said to be 'carrying on a business' in the UK. They obviously take a range of factors into account – a mere listing on the London Stock Exchange or just the fact of having a UK-incorporated subsidiary would not necessarily mean the Act applies."

Kenneth Clarke, Lord Chancellor and Secretary of State for Justice, at the release of the Ministry of Justice's Guidance on the Bribery Act, 30 March 2011.

We said...

"The integrity of the London financial market is one of its greatest advantages. A potential carve-out of overseas issuers from the Bribery Act's purview would challenge this reputation and disadvantage UK companies that are prohibited from corrupt activities under the act."

F&C letter to the editor, Financial Times, 29 March 2011.

They said...

"What constitutes economic engagement or carrying on business in the UK as the Act puts it? When is the engagement so insubstantial that it can be ignored and when does it cross the line and become substantial and demonstrable? It will be for the courts to decide on these and other issues. For example, what is involved in the company's listing? Is the company trading in the UK? Is it raising finance? Is it spending time dealing with numerous stakeholders such as shareholders? What corporate functions are carried out in the UK? I think it is right that we probe this in particular cases in order to see whether, on the natural construction of these words, the activity involved does satisfy the test."

Richard Alderman, Director, Serious Fraud Office, following publication of the Ministry of Justice Guidance on the Bribery Act, 7 April 2011.

[5] See: http://www.fandc.com/FundNets_FileLibrary/file/Investor_letter_to_UK_Prime_Minister_regarding_UK_Bribery_Act.pdf
[6] "Investment groups seek Bribery Act assurance", Financial Times, 29 March 2011: http://www.ft.com/cms/s/0/db911444-598b-11e0-baa8-00144feab49a.html#axzz1KisSGP2l
[7] "Fraud chief vows tough stance on Bribery Act", Financial Times 30 March 2011: http://www.ft.com/cms/s/0/a7c5d7b2-5b07-11e0-a290-00144feab49a.html#axzz1KisSGP2l

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