

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:

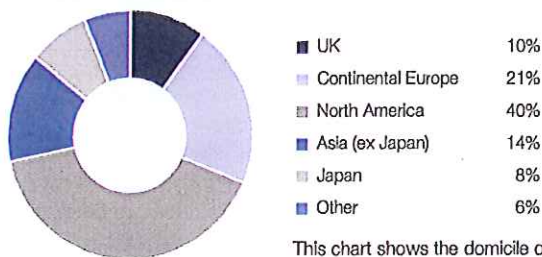
- A 17-person team of Governance & Sustainable Investment specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary
- Global engagement across all markets
- 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	161
Business Ethics	80
Sustainability Management & Reporting	519
Environmental Management	0
Ecosystem Services	13
Climate Change	426
Labour Standards	70
Human Rights	42
Public Health	13

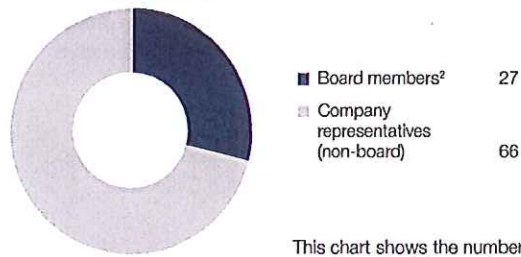
Number of milestones achieved	79
Total number of companies engaged ¹ this quarter	603
Number of countries	47
Company meetings voted	4137

Geographical spread



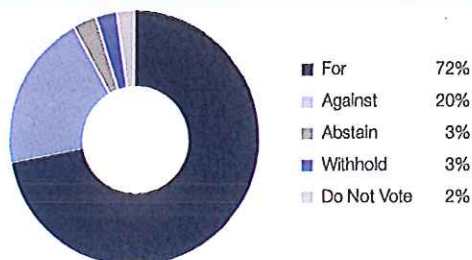
This chart shows the domicile of companies that have been engaged by F&C in the last quarter.

Number of company meetings



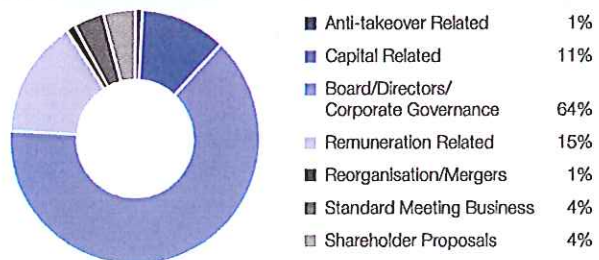
This chart shows the number of company meetings – both face to face and by telephone – carried out by F&C this quarter.

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 Includes Named Executive Directors in the US.



re^o® viewpoint

Elizabeth McGeeveran, Senior Vice President Governance and Sustainable Investments, Boston, and George Dallas, Director, Corporate Governance, London April 2012

We are the 55%

In a stunning turn of events early in the 2012 voting season, 55% of shareholders in US financial giant **Citigroup** either voted against or abstained on the company's executive pay plan. The New York Times says this is the first time a large US bank has been on the receiving end of such a decisive shareholder rejection of a remuneration scheme. A much tamer shareholder base in 2011 had handed Citigroup a 93% tally in favour of its pay plan, evidently leaving the company unprepared for this drastic swing in results. The vote has begun to cause ripples of concern throughout bank boardrooms across Wall Street and beyond.

What caused the fuss?

Citigroup's remuneration package included the \$15 million awarded to Vikram Pandit, the company's Chief Executive Officer. While Mr. Pandit has indeed begun to show some progress in turning the bank around, the job is far from finished, and equity holders continue to feel the pain – a \$100 dollar investment in Citigroup at its share price peak in 2006 is currently worth around \$4.60.

F&C counted itself among the 55% of investors who voted against Citigroup's plan, and has also objected to the bank's approach in past years. Although the Board is quite new and important reforms have been introduced, F&C remains disappointed with the highly subjective and often lax performance conditions. We are particularly concerned about the overly generous retention awards to senior executives, as these appear to be attempting to make amends for the downturn they experienced in previous years' pay. F&C believes that these retention awards undermine the spirit of variable pay.

F&C also questions the decision to make long-term performance-based payouts in cash, as best practice for long-term awards calls for granting shares. It appears that a cash payout is one way around Citigroup's substantial equity retention requirements.

Exacerbating these concerns is the recent announcement that dividends to shareholders are not likely to increase: this shines a spotlight on the question how distributions between company management and shareholders must evolve as bank business models shift towards lower levels of profitability and volatility – a key question that banks remuneration committees will grapple with in the wake of sector reforms on capital adequacy.

And meanwhile across the Atlantic...

Within two days of the Citi vote, shockwaves were already being felt in the UK, as the equally heated debate over bank pay turned swiftly to **Barclays's** imminent AGM vote. The company has, in recent years, come under considerable public criticism and scrutiny over its levels of executive pay, and promptly announced the introduction of tougher bonus conditions, along with a promise of higher dividends. The olive branch includes Chief Executive Bob Diamond's offer to forgo half of his £2.7 million bonus for 2011 until the company's return on equity exceeds its cost of equity. The latest remuneration package is scheduled for a vote at the bank's Annual General Meeting on April 27th. It remains to be seen how investors will react to these developments. F&C is reviewing the Barclays proposal ahead of next week's AGM.

What next?

These dramatic developments at Citigroup and Barclays highlight how the balance of power is shifting between investors and management executives at major financial institutions. Through the 2012 voting season, F&C will continue to be a constructive and critical voice in the debate about bank pay, as regards both individual executives and aggregate pay. We consider it very encouraging that what started as a few dissident investor voices is now being echoed by a critical mass of investors who are recognising the crucial role that pay incentives have on overall corporate risk and performance.

In addition, the debate has moved decisively into relatively unfamiliar territory for the investor community: the question of fairness of executive pay. Whereas historically, F&C and most fellow governance advocates argued their case in terms of alignment of incentives rather than absolute pay levels (a.k.a. quantum), serious questions are now being raised about the reputational risks that banks face in this regard. F&C therefore believes that remuneration committees will increasingly need to justify publicly the quantum of pay in financial institutions, as well as the complex formulas that underpin them.

More detail on F&C's current thinking behind bank remuneration can be found in **re^o® Viewpoint "Banks and remuneration: what investors should be looking for and asking for"** (March 2012).

They said...

“ Barclays' executives are convinced the new conditions are largely meaningless ”

Diamond teaser keeps investors at bay, Patrick Jenkins, *Financial Times*, 20 April 2012

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Walmart Stores in high-profile bribery scandal

What happened?

Investors in **Walmart Stores** (a.k.a. **Walmart**) were stunned over the weekend by allegations that the American retail behemoth is embroiled in a massive corruption scandal involving its Mexican affiliate, **Walmart de Mexico** (a.k.a. **Walmex**). On Sunday 21st April, the *New York Times* ran a four full-page report¹ chronicling how a senior member of the legal staff at Walmex had, back in 2005, alerted US headquarters to the existence of a sophisticated system of bribery aimed at securing favourable treatment from municipal authorities, including building permits, confidential information and fine cancellations. The payments, made by specialised intermediaries known as *gestores*, were then allegedly "purified" by an elaborate accounting and billing system to disguise them as legal fees.

What shocked Walmart watchers more than the existence of the bribery itself was the company's response: rather than pursue the matter fully as dictated by its policy, it reportedly suppressed the matter, rejecting its General Counsel's advice to bring in independent legal experts, and entrusted the matter to the Walmex management to self-investigate. Unsurprisingly, the Mexican team found the charges to be groundless, the whistleblower was sidelined and accused of dishonesty, and the matter was put to bed. This, the *Times* claimed, was done with the full knowledge and backing of certain top management in Bentonville, many of whom have risen still further to the uppermost echelons of the parent company – including the current CEO, Michael Duke (then Vice Chairman, Wal-Mart International) and Vice-Chairman, Eduardo Castro-Wright (then CEO of Walmex).

Until, that is, it resurfaced on the front pages of one of the world's leading newspapers, causing the share prices of Walmex and Walmart to plummet by 16% and 7.5% respectively after two days of trading.

Walmart promptly announced that it had reassigned the General Counsel of Walmex, adding that it was "deeply concerned," and professed to be "working aggressively to determine what happened."

Why the shock factor?

Although much maligned in labour circles for its fiercely anti-union stance, Walmart had won respect for its famously uncompromising anti-corruption standards – right down to Walmart staff refusing to accept a lowly cup of coffee from outside parties. The company suffered one highly public ethics

incident in 2005, when the vice chairman and executive director was found to have embezzled up to \$500,000 worth of gift cards by filing claims for fictitious anti-union consulting expenses – a double-whammy that earned the wrath of pro-labour and anti-corruption activists alike. F&C had engaged intensively at that time with public pension funds to press for stronger whistleblower protection systems, so as to ensure that corrective measures taken in the wake of this scandal found their way through to the trenches. The company was adamant that its control systems were sound – and by and large, F&C thought it had a handle on anti-corruption, even though it needed to strengthen its whistleblowing systems and introduce independent evaluation of its control systems related to employees. More generally, F&C had consistently tested Walmart and Walmex's business ethics practices on repeated occasions – including:

- In 2004, we invited Walmex to participate in a workshop specifically aimed at ensuring that agents and intermediaries avoid paying bribes. As highlighted by the current scandal, intermediaries are the Achilles' heel of corporate anti-corruption systems.
- In 2005, we shared *The Ethics of Influence* with both companies – a set of best-practice guidelines we had sponsored on how to engage with public officials while maintaining high ethical standards. Walmart's business is especially vulnerable to this risk, given its dependence on securing permits to build new stores.
- In 2006, we wrote to alert the companies to the UN Global Compact *Guidelines on Bribery and Corruption* issued by Transparency International and describe key indicators of effective anti-bribery and corruption systems.
- In 2006, we wrote to company leaders at both Walmart and Walmex to remind them of F&C's expectations in relation to good governance, sound controls and anti-corruption standards.
- In 2010, we met one-on-one at Walmex's Mexico City headquarters, to discuss, among others, whistleblower protections and the importance of independent external oversight to ensure their effectiveness. We concluded and fed back to management that it was overly reliant on its "zero-tolerance" posture to keep employees on the right path in terms of employee management and business ethics, and warned that managers were not always best positioned to catch wrongdoers. Clearly our caution was warranted.

¹ "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle", *New York Times*, 21 April 2012 - http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?_r=2

For all its foibles with critics, Walmart had undoubtedly earned the trust of the market on this one issue – just as it has on its razor-sharp focus on environmental best practice, which has included setting ambitious climate change and energy efficiency targets and driving through a major programme of improvements through its vast supply chain; indeed, in so doing, it has raised de facto standards for hundreds of thousands of companies. Could the credibility of this too now be called into question?

What does this mean?

This incident has provoked consternation, not just because of what it says about the much-vaunted excellence of the Walmex growth machine, but because of the clouds it casts over the credibility of Walmart's current top management, many of whom are alleged to have been actively involved in suppressing the case. Will heads roll as a result, as happened at **Siemens** when similar scandal struck? Will further investigation recognise those employees who stuck closely to the spirit of Walmart's anticorruption policies?

In addition, this incident raises questions about the credibility of other companies' professions of strict adherence to tough anti-corruption standards. As accusations swirl about Walmex' and Walmart's brazen hypocrisy, old objections are being recycled about the supposed impossibility of doing business "in certain places" without the customary "grease" payments to oil the wheels of business. Coming from the one company, that through its sheer scale and corporate discipline, has the clout to drive change in standards of business ethics, this incident will be sure to shake confidence in such efforts globally.

Compounding such concerns is the notable counter-example of **Ikea**, the Swedish retail giant that is one of Walmart's few global peers – but for its private ownership. Ikea famously and publicly refused to pay bribes when it entered Russia – going so far as to cancel the grand opening of its flagship store in Moscow in 2000 in protest at a shakedown from a local government official – and pledged to do business in that country without corruption. At the time, cynics claimed that Ikea took this uniquely principled (and public) stance because it could: it had only its family shareholders to worry about, and they were determined to stand their ground, irrespective of the impact on the bottom line. But alas, the story has a less happy ending: Ikea threw in the towel in 2009, announcing a freeze on all further investment in Russia due to the impossibility of conducting business in line with its principles.

And what does this incident say about the resilience of the Walmart business model? Mr. Castro-Wright had been viewed by the markets as the Walmex manager with the Midas touch, who was being groomed as a possible successor to the CEO and had been brought to US headquarters to repair the struggling US business – yet he failed to replicate the success he had had achieved in Mexico, and was sidelined. Could this be a reason?

What next?

Dismaying as this incident may be, it is an opportunity to be grasped: Walmart will emerge from this badly bruised, but F&C believes this is the time to press for a genuine change in culture at the very top, as well as real evidence that the efforts of whistleblowers will be rewarded, not punished, so as not to discourage future reporting of wrongdoing.

F&C will continue to work collaboratively with its longstanding investor partners, particularly the Interfaith Center on Corporate Responsibility and several major European pension funds, whose past focus has been on Walmart's approach to sweatshops in the supply chain, labour practices in US stores and disclosure.

In addition, F&C will:

- In the short term, gather the facts: this may be difficult as companies become closed-mouthed once government investigations are opened.
- In the medium term: identify actions that will demonstrate that Walmart's leadership has taken real responsibility for corruption failures and the alleged cover-up. We will look for real accountability, including a fully independent forensic examination, clear evidence that the company's stated zero-tolerance policy is being applied equitably (i.e. including the top management, if justified), and a plan for what needs to change, how it will change and by when.
- In the long term: revisit how best to make progress on other important areas of engagement, such as treatment of employees, human rights, supply chain management and more. Over the last 11 years, we have been both encouraged by Walmart's concrete steps forward and discouraged by its slow progress in key operational areas. However, given that this is the largest private employer in the world and a global retailing powerhouse that sets standards across the sector, stopping our engagement is not an option.

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