



Shropshire County Council

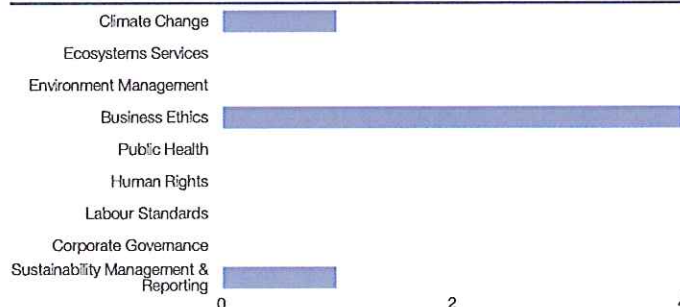
Responsible Ownership Activity Report Q4 2012

The purpose of the **reo**[®] (responsible engagement overlay)* service is to engage with companies held in portfolios with a view to promoting the adoption of better environmental, social and governance (ESG) practices. The **reo**[®] approach focuses on enhancing long-term investment performance by making companies more commercially successful through safer, cleaner, and more accountable operations that are better positioned to deal with ESG risks and opportunities. Through a combination of constructive dialogue and active share voting, **reo**[®] works to drive behavioural change with companies, and records successful outcomes as 'milestones' – changes in corporate policies or behaviour following intervention.

Companies engaged this quarter

Companies engaged	40
Milestones achieved	6
Countries covered	1

Milestones achieved by issue



Companies engaged by country



Companies engaged by issue**

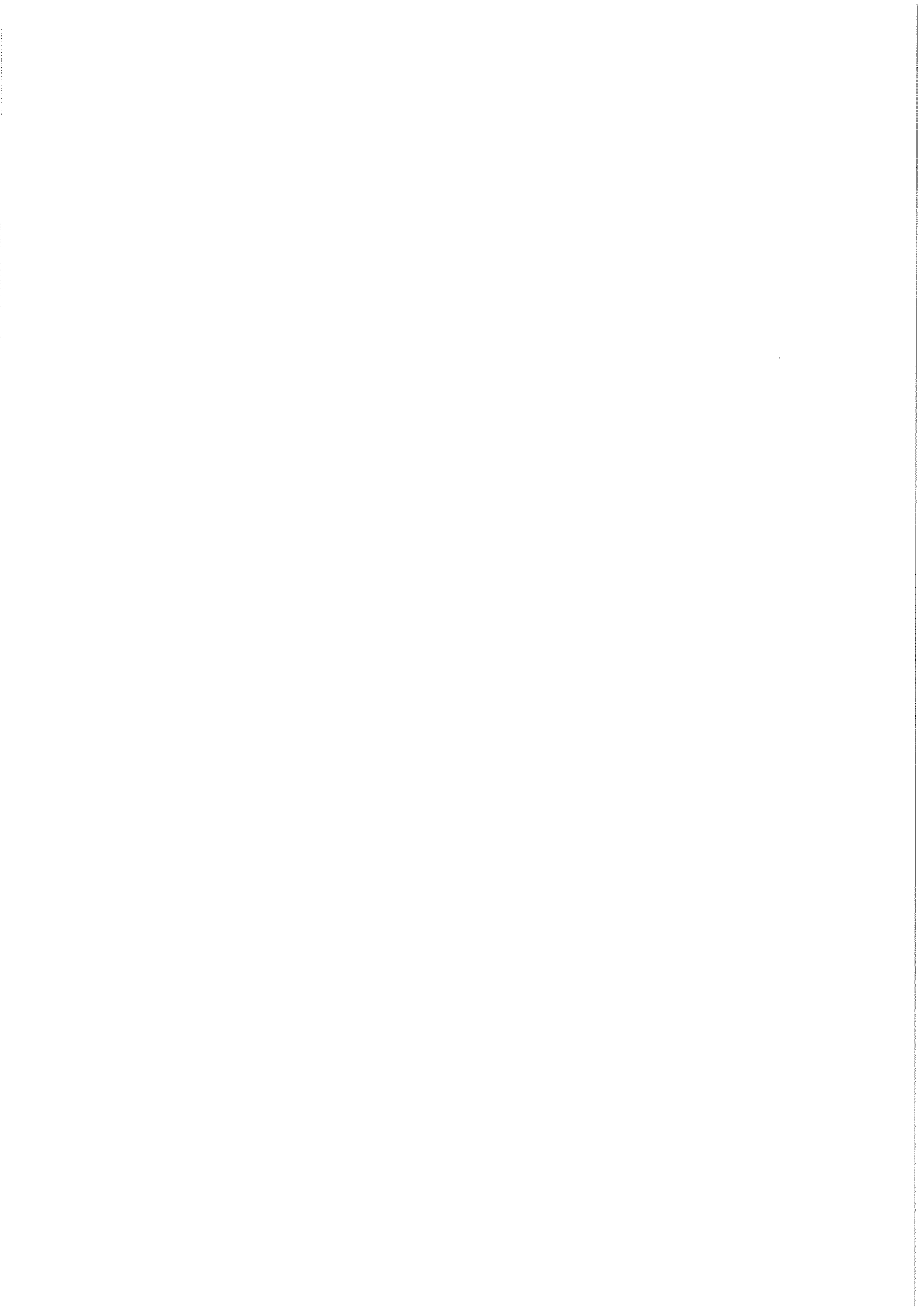


* **reo**[®] is currently applied to £84.8 billion (€106.4 billion / \$136.9 billion) of assets as at 30 September 2012

** Companies may have been engaged on more than one issue.

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To: reo® clients
From: Elizabeth McGeveran, Senior Vice-President, Governance & Sustainable Investment
Re: Syria Update
Date: 12 October 2012

Background

F&C has engaged with companies operating in Libya and Syria following the 2011 'Arab Spring.' Our long-standing engagement programs related to internet freedom, human rights risk management and revenue transparency ask companies to ensure that they have strong policies and training for executives and staff. This is to ensure they respond correctly during conflicts, such as that occurring in Syria and support important structural reforms in times of social rebuilding. Whilst reaching out to various operators, we have pursued additional dialogue with the following companies:

- Eni (Italy)
- Finmeccanica (Italy)
- Mitsubishi (Japan, meeting in Tokyo)
- MTN Group (South Africa)
- NetApp (US)
- ONGC (India, meeting in Dehli)
- Royal Dutch Shell (Netherlands/UK)
- Total (France)

Below are recent updates on our engagement with NetApp and Finmeccanica in relation to Syria.

NetApp

Background: US law has prohibited American companies from doing business in Syria. NetApp, a US-listed company, is accused of selling computer storage equipment to a private Italian company with some knowledge that it was intended ultimately for an internet surveillance system in Syria. In March 2012, NetApp made a public statement condemning the use of its products for repression, however, as the company is the subject of a US government probe, it was unwilling to make comments about the Syria allegations.

Update: F&C met with NetApp to follow-up on past engagement regarding labour standards in the company's supply chain and to raise compliance with export controls and economic sanctions laws. The company was unwilling to disclose more information on its trade compliance given the ongoing government probe. However, F&C did learn that the company has completed an internal investigation by an independent third party into its own practices. NetApp has shared the results of this investigation with the US government and informed F&C that broader disclosure of its findings depend on a timeline set by the government. The company also informed F&C that while 80 percent of company sales come through its partner channel, as was the alleged route of NetApp technology to Syria, it has significant visibility into its partner channel. In addition, in May 2012, the company published an updated Code of Conduct, including an expanded section focused on export controls and restricted country laws. It assured F&C that all employees have been trained in compliance with this new code.

F&C Assessment: NetApp's unwillingness to discuss Syrian allegations is not surprising given it is working to resolve an open case of trade sanction violation with the US government. Through cooperation with government investigations, US companies seek to arrive at settlements that usually include fines and steps to strengthen processes and internal controls. With such negotiations ongoing, companies will rarely put much additional information into the public domain. However remote the chances of substantial new reporting by the company, F&C believes that our enquiries highlight to NetApp that investors are interested in evidence of stronger controls and practical changes that will help the company stay firmly on the right side of the law.

Next Steps: F&C plans to contact NetApp again in six months, when it may be more willing and able to speak freely about steps it has taken to ensure trade compliance with US sanctions. We will also continue encouraging the company to keep up the pace in addressing labour risks in its supply chain, as it has not kept pace compared with its peers.

Finmeccanica

Background: In 2010, through its subsidiary Ansaldo Energia, Italian industrial conglomerate Finmeccanica contracted with a Syrian public electricity generation company to supply gas turbines for a combined cycle plant on a site in Deir Azzour. It worked with Syria's PEEGT (Public Establishment of Electricity for Generation and Transmission), in a consortium with Greek company Metka. Most recently, the EU has blocked EU-regulated companies from constructing new electric power plants in Syria from September 2012 onwards.

Update: In a meeting with F&C, Finmeccanica described that it has a risk management process in place and closely monitors conflict-prone countries, including Syria. Finmeccanica has indefinitely suspended its contract with the Syrian public electricity generation company due, not only to the EU ban, but also because of security concerns around the company's personnel. The company has not issued a press release, but this information is publicly available. Finmeccanica confirmed that the suspension of the contract is not particularly material, as the project is worth €160 million (i.e. less than 1% of revenues in 2011). However, the company hopes to re-initiate the contract once the EU ban is lifted and the situation in Syria is more stable. When asked about human rights management systems and monitoring, the company notes that it has a dedicated section on human rights in its sustainability report. It was also proud to have been recently admitted to the Dow Jones Sustainability Index, making it the only defence company in the index.

F&C Assessment: Finmeccanica no longer has operations in Syria. At the current time we do not anticipate immediate follow-up engagement on Syria. However, depending on how the Syrian conflict is resolved, F&C may consider some additional engagement requests about how companies can help to build a more transparent and secure operating environment in Syria.

Next Steps on Libyan and Syrian operators

As the situation in Syria continues to deteriorate, in addition to engaging with NetApp and Finmeccanica, we will undertake engagement in the following areas:

- We will continue to request a meeting with the management of MTN Group to discuss our concerns regarding the company's operations in the Middle East. We have already shared these with the company, who have been hesitant to meet with us directly to discuss these in more depth.
- We will follow-up with ONGC, which is considering introducing more international reporting on its operations in Syria and Sudan, and is reviewing a group-wide human rights assessment system. The company is no longer operating in Syria, but it could resume operations there in future depending on the political situation.
- We will continue our work with major oil and gas companies that are re-entering post-conflict countries such as Libya – and possibly, one day, Syria. It is crucial for companies to encourage their home and host governments to set up more transparent systems to prevent corruption around extractives revenue. In particular we are promoting participation in the Extractive Industries Transparency Initiative (EITI) in Libya.

If you would like further details on the information in this note, please contact your **reo**[®] client director.

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To: reo® clients
From: Mirza Baig, Director, Senior Adviser, GSI
Re: Posco: Korean steel company's clash with Indian NGO goes public in The Netherlands
Date: 09 November 2012

Summary

Back in 2005, South Korean steel maker, **Posco**, announced it planned to set up a steel plant in the Indian state of Odisha (formerly known as Orissa). Since that time the company has faced challenges and growing public criticism, including a co-ordinated campaign by an Indian NGO due to alleged human rights and environmental abuses. Formal complaints have been made to the Dutch, Korean and Indian governments – and some Dutch investors have subsequently started to come under public pressure.

On your behalf, F&C has a long track record of engagement with Posco and has recorded milestones linked to the company improving its systems for managing human rights and supply chain issues, although there remain significant shortfalls in its practices. F&C's engager, located in India, plans to continue to engage Posco, at a corporate level and also directly with its project managers in India who are at the eye of the storm. We will continue to focus on Posco developing more robust corporate policies and systems and improving its public disclosure.

Background

- Posco has been actively looking to expand its global operations and diversify revenue and assets outside of Korea, which F&C is broadly supportive of, provided it is managed appropriately. The company is currently looking to buy assets in Australia.
- Posco's announcement of plans to build a 12mtpa steel production facility in 2005 in the Indian state of Odisha was very significant both for the company and India as the \$20bn project represented the largest single foreign direct investment into the country.
- It appeared that Posco management somewhat naively assumed that as the deal was brokered by the Indian prime minister that the project's pathway would be smooth. This was clearly not the case as seven years on, the land for the project has yet to be handed over to the company. In fact, the project has been mired in controversy and obstacles from the beginning, including legal challenges to mining rights, and

continuous granting and overturning of environmental clearances. However, the most controversial aspect of this has been the **acquisition of the land** and management of **community relations**.

- Posco's approach appears to have been reasonable from a legal perspective. However, allowing local government officials to lead and shape the process coupled with a lack of proactive initiatives from the company's side, demonstrated Posco's lack of sensitivity to the complexity of doing business in the region.

F&C acts for reo® clients

We have been engaging with Posco management since 2008, including meetings over the last 12 months with executive directors of the group in Korea as well as local management at Posco India in New Delhi who are responsible for overseeing the Odisha project.

Key engagement asks included:

- Develop formalised and comprehensive group-wide human rights policies.
- Develop specific systems to manage community consultations including a framework around Free, Prior, and Informed Consent.
- Enhanced reporting demonstrating how group policies are implemented at a project level, particularly at high risk operations. Specifically recommended detailed reporting of the Odisha project due to its risk profile and public scrutiny.

Indian legislation around mining rights and particularly land acquisition is complex, outdated and inadequate to deal with the myriad of issues they were designed to address. This has been acknowledged by the government who have unsuccessfully sought to gain parliamentary approval for a number of revisions to the land acquisition, rehabilitation and mining acquisition acts. In light of the legislative and administrative gaps, doing business in the region requires local knowledge, and highly developed and sophisticated policies and procedures to manage environmental impact assessments (EIA) and relations with local stakeholders. On paper Posco had neither and sent a Korean team from the head office to manage the project who appear to have been learning on the job and have been in "fire fighting" mode since the project started. Discussions with Posco India staff confirmed that the whole experience has been a culture shock for them.

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To put local industrial development into a broader Indian context, **Tata Steel** is widely considered to have the most developed and effective rehabilitation, land acquisition, community consultation and social investment policies. In meetings they have been very emphatic that they cannot rely on local government officials to lead the process of securing a project as these people come and go during the life of the project, tending to be aggressive with local communities and out-of-step with the company's own philosophy. Despite being applauded for setting up initiatives such as the 'Tata Family' which provide exceptional benefits to project-affected people, Tata Steel has suffered similar project delays in the region due to community unrest. It has built flexibility into project plans to deal with this and remains committed to winning gradual support through demonstrating the success of their community investment programmes. So even with cutting edge policies, social unrest around a major project is not unusual within a local context.

Another problematic issue for Posco is that the government, particularly as the election period looms, is keen to demonstrate that foreign companies are making concessions to the benefit of the local community. During the renegotiation of the Memorandum of Understanding this year, the State Minister was featured prominently in the press describing how he has forced Posco to increase commitments on local investment and training and hiring of villagers. While this is somewhat a misrepresentation of the dynamics of the relationship between the parties, it is the reality of local politics that the company has to operate within.

An Indian NGO, Lokshakti Abhiyan (The National Alliance of People's Movement), has initiated a campaign against Posco claiming that it has been complicit in the violation of the rights of local tribesman due to a lack of consultation during the land acquisition process and that the company had failed to undertake adequate environmental impact assessments. Posco has taken a very aggressive stance in refuting the allegations and also insinuated that the NGO is motivated by a political agenda of a secret funder. This accusation against NGOs is becoming increasingly common and has been levied at the anti-nuclear campaigners in Southern states as well as Survival International who brought to light human rights failings at global miner **Vedanta**. While F&C is not in a position to research allegations of so-called "secret funders," we do strive to understand the various parties in a conflict over corporate practice. The National Alliance of People's Movement was established in the 1990's and tends to adopt anti-business agendas and appears to be more focused on halting exploitation of natural resources by domestic and multinational corporations rather than social development. The group is linked, at least philosophically, with the militant Naxalite movement and we are not persuaded that their allegations of extreme community disruption and opposition to Posco are impartial.

Engagement results

Our engagement with Posco has led to three recordable milestones to date:

- 1) In 2012, Posco India initiated a **targeted outreach to investors** on the nature of its operations in Odisha, the timeline of milestones and key incidents that have taken place over the last seven years, and the company's perspectives on the causes of the delays. The company also outlined the activities it has undertaken to meet its environmental and social obligations related to the project. This is the first time the company has sought to communicate directly on the challenges of its Odisha project and is an important step in rebuilding investor trust in management and the future prospects of the project.

- 2) In 2011, Posco published a **human rights policy** that applies to **company employees** worldwide. The policy was based on the International Labour Organisation's (ILO) Core Conventions and is implemented via a human resources management system that is built to reflect local labour conditions and cultural practices. This revised approach to protecting employee labour standards is a good start to managing labour risks as the company expands in many markets with relatively poor labour standards, including India and Myanmar (Burma).
- 3) Also in 2011, Posco introduced a **supplier code of conduct** specifically requiring suppliers to protect their employees based on the ILO Core Conventions. As the company expands outside of Korea and sources iron ore from emerging markets, the social risks in its supply chain grow and must be more proactively managed.

F&C assessment and next steps

F&C's engagement with Posco indicates the challenges facing Asian companies as they seek to expand in emerging markets, such as India, and the importance of sustainability issues to their success and the protection investor value.

The fact that the project has not moved forward markedly in the seven years since signing the initial MOU with the Odisha Government is of serious concern. In fact, as investors we consider the company to have lost ground as the terms of the MOU have now been revised, the project down-sized and key mining and environmental clearances remain outstanding – in other words this project has been mismanaged. While there are mitigating circumstances, the experience has highlighted a level of naivety of management in their due diligence of such a landmark project. It has also underscored significant gaps in Posco's sustainability-related policies and procedures. It naturally raises serious questions over the credibility and competency of Posco's management in overseeing future international growth opportunities. Nevertheless, there is no credible evidence at present that the company has operated outside of the Indian legal framework nor that the company has been complicit in human rights abuses.

We will continue to engage with the company at a corporate and project level with a focus on the development of robust corporate policies and systems and improved stakeholder reporting. Evidence of progress would include:

- 1) Revised human rights policy which explicitly addresses the management of relations with project affected peoples;
- 2) Disclosure of systems to implement and monitor compliance with human rights policies at a project level;
- 3) Formal reporting of community consultation, dispute resolution, rehabilitation practices and social investment at its Odisha site; and
- 4) Independent verification and reporting of its social and environmental practices.

For more details please contact
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 or your client director.

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For further information on F&C's reo® engagement services please contact
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ESG issues begin to rate in fixed income

In an important new development, the credit rating agency Standard and Poor's (S&P) recently announced an updating of its rating criteria, which will now explicitly include environmental and social factors as areas of material risk that can affect a debt issuer's credit quality.¹ This announcement follows F&C's engagement with S&P as part of its reo[®] for bonds programme, which included a response to S&P's public consultation in April 2012 on its criteria for assessing management and governance factors.²

Investors lead the call for change

Until this announcement S&P's management assessment criteria had incorporated corporate governance factors into the credit rating process, but S&P had been silent on environmental and social risks. F&C actively encouraged S&P to adapt a broader perspective on risk by underscoring that ESG (environment, social and governance) factors can have a significant impact on business performance, financial strength and credit quality.

We acknowledged in our consultation that among the many risk factors that influence a company's credit rating, ESG factors are not always the main risk drivers. But we also stressed that investors should expect that credit ratings should actively take into consideration environmental, social or governance risks and their potential materiality to the credit rating. While we do not believe that rating agencies should mechanically force ESG issues into a credit rating outcome, we did urge S&P to deliver at least an opinion of ESG risk materiality, which we believe would be of great use to investors.

As a member of the Principles for Responsible Investment (PRI) workstream on responsible investment and fixed income, F&C had also brought this S&P consultation to the attention of the PRI. F&C successfully encouraged the PRI to submit a response to this consultation, and provided input and support to the PRI's submission, which also called for integrating ESG analysis more robustly into credit ratings. A prominent UK-based insurance company, Standard Life, also responded to the S&P consultation, citing its support of F&C's submission.

The influence of credit ratings as a passport to global debt markets

This is an important milestone in linking ESG issues with fixed income investment. As one of the world's leading credit rating agencies, S&P plays a very influential role in global credit markets. While the major rating agencies (S&P, Moody's, and Fitch) have been under attack for their failed ratings of

sub-prime securities leading up to the recent global financial crisis, credit ratings still have a critical function – effectively serving as a “passport” for companies into public financial markets and strongly influencing a company's cost of capital.

By explicitly recognising the impact that ESG factors may play in affecting corporate credit quality, this shift in ratings criteria should increase the focus on ESG risk factors by both corporate debt issuers and fixed income investors. In particular, for companies seeking to take steps to improve their credit quality and credit rating, it is now clear that better management of ESG risks will be part of the process. This will provide a positive incentive for companies to improve their ESG risk management and governance of sustainability issues more broadly.

The S&P criteria shift will not escape the attention of other key rating agencies, including Moody's and Fitch, and should also prompt these other agencies to consider adopting similar criteria. We believe that the net effect should be a virtuous cycle of greater attention to ESG in the fixed income markets and more proactive management of these issues by companies.

A good start, but more to do

F&C responded to S&P by offering congratulations on this positive criteria development. We also noted that there is more work to do by rating agencies to factor ESG issues more explicitly into sector analysis, as many of the major banks are now doing for their own lending and underwriting activities. The materiality of potential environmental and social risks will vary from sector to sector depending on the specific industry characteristics, particularly in high impact sectors such as oil and gas, mining, and forestry. While S&P's management criteria will now be reflecting ESG issues, it will also be important for S&P and other rating agencies to have a clear sense of which ESG factors may be most material in assessing companies in individual sectors.

At a time when the performance and credibility of rating agencies is under broad scrutiny by regulators and investors we believe it is important for S&P and other major rating agencies to ensure that their approach to ratings is robust and reflects the broad array of risks that can affect companies and their credit quality. Ongoing engagement with S&P will remain an important part of F&C's reo[®] for bonds programme. We believe this development positively complements and leverages the impact of F&C's fixed income engagement on reo[®] client bond portfolios.

¹ “How we rate management and governance factors”, Standard & Poor's, 13 November 2012

² See: http://www.fandc.com/FundNets_FileLibrary/file/SP_Consultation_April_2012_Final.pdf

We said...

“ Perhaps the most fundamental point of feedback is our concern about the lack of any reference in the criteria as to environmental, social or ethical factors—and how these can create reputational, operational and financial risks for companies...we believe there is scope for more explicit consideration and recognition of the extent to which these factors are incorporated into a company's enterprise risk management system and the extent to which the company's board demonstrates sufficient oversight of these issues.”

F&C Investments: Response to Standard & Poor's Request for Comment on Management and Governance Factors, April 2012.

They said...

“ What about ESG? Why were social and environmental factors not considered originally?

We received significant feedback [in the S&P consultation] about the role of environmental, social, and governance (ESG) factors as a source of material risk to corporate financial performance. We were reminded that matters like climate change and employee relations are no less risks to an enterprise than, for example, deficiencies in management expertise or board effectiveness. We found this feedback persuasive--and all the more so in the context of initiatives that Standard & Poor's has undertaken, for example, to promote global consistency and analytic rigor on matters like climate change, clean energy, and the impact of regulations restricting the emission of greenhouse gases. Consequently, under the comprehensiveness of risk management standards and tolerances subfactor we have added specific reference to the management of environmental and social risks.”

“How we rate management and governance factors”, Standard & Poor's, 13 November 2012

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