

The **co-operative**  
asset management

# Responsible Investments Quarterly Review

Winter 2011



## Section 1



### **Engagement Update**

3

An Indian power story: our takeaways  
Mutual concerns  
Improving slaughter standards  
Window of opportunity for fishing reform in Europe

---

## Section 2



### **Corporate Governance**

9

Consultation Fever  
Diageo AGM  
Olympic Games  
Conflict of interest removed at mining company

---

## Section 3



### **Murdoch Myopia – Short-sighted governance**

15

## Section 4

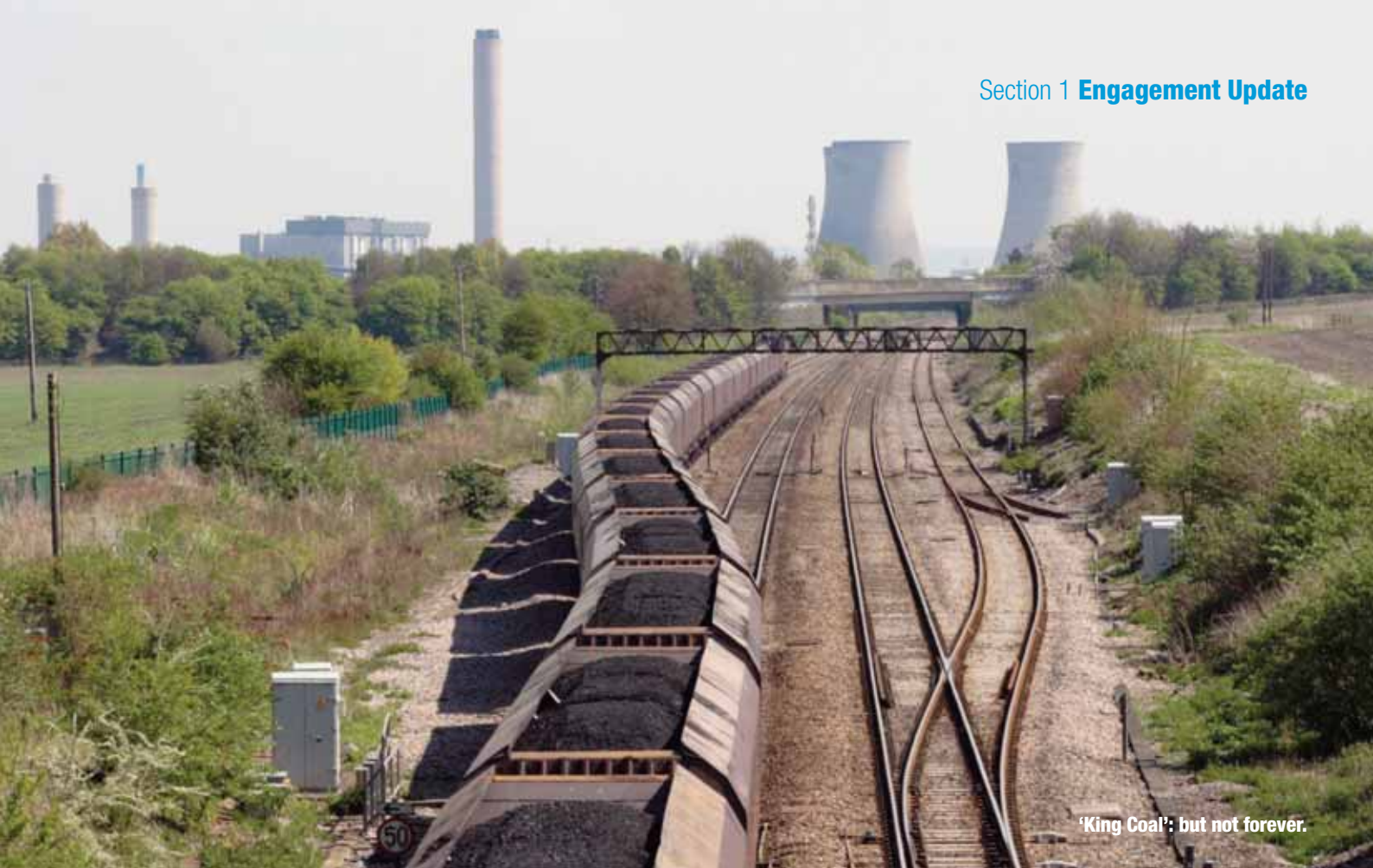


### **Recent Developments**

19

CDP Water: one year on  
National Employment Savings Trust

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# Section 1 **Engagement Update**

## **An Indian power story: our takeaways**

Perhaps our most in-depth example of both company engagement and the integration of environmental, social and governance (ESG) considerations into financial valuations in 2011 was with Essar Energy, the Indian company that early last year listed as a FTSE100 company in London. Its implied valuation on listing was based not on its physical assets at the time but its plans to increase its electricity generation capacity six-fold by 2014 to supply the domestic market.

The investment case and the ESG risks surrounding its ambitious execution plan were finely balanced. On the one hand, the Indian economic growth story was beginning to be constrained by a stark shortfall in power supply against expected demand, which could only be relieved by building more power stations. On the other, the only way to satisfy this demand at prices Indians could afford was to use the plentiful sources of domestic coal, at a time when developed regions are all but abandoning it for environmental reasons. Add to this the complications that Essar Energy is enmeshed within a larger dynastic conglomerate that dominates its board and the fact that India itself is going through a governance crisis crystallised in ongoing scandals and public agitation over bribery and corruption. We did not want Essar Energy to become the next Vedanta Resources, whose proposed bauxite mine was eventually killed off by a long-running and very public campaign galvanised by the plight of an indigenous community.

## **The dilemmas of being a 'responsible investor'**

We have never invested in Vedanta because of its track record of controversy. What Essar Energy had in common though was a delicate socio-political landscape to navigate. So was Essar Energy investible? Three questions had to be answered: was it responsible of us to invest in a coal-based power company, one that would benefit from a comparative lack of tough regulation enforcement? If so, what was the correct price to pay for such a company, giving the ESG issues their proper due? And what could be achieved through engagement to reduce the ESG risks? Though Essar Energy was obviously unsuitable for our 'Sustainable' range of funds, our whole-of-market funds are meant to uphold responsible investing through integration and engagement for better standards of corporate responsibility, not avoid perfectly legal activities that are controversial in some quarters. The ethical debate was not one-sided either as one had to consider too the manifest need of ordinary Indians for affordable power. However the over-riding argument had to be that our whole-of-market funds do not have the luxury of avoiding uncomfortable sectors if we believe the investment case provided superior returns potential for our customers.

We found that even after building in a heavy discount to the valuation, that is, lowering what we thought was a fair price to pay for the stock to reflect our ESG concerns, the share price suggested headroom for positive returns (after the shares had fallen back substantially from their peak levels). We invested with the proviso that

we would seek to engage the company on ESG performance. The aim was both to assess the company's true capability to manage these risks and recommend ways in which it could reduce risk, thereby lowering the 'insurance premium' we were paying to own the stock.

**A pressing engagement**

In common with other institutional investors we were also minority shareholders compared to the dominant shareholder, the Ruia family, which has executive roles on the board. We sought support from other large shareholders on a common agenda for maximum impact and had the opportunity to present our concerns at a meeting in London. Essar Energy were pleased with the opportunity to address so many large shareholders at once and the chief executive played a confident role, flanked by his Corporate Social Responsibility (CSR) and safety team in India and company secretarial team in London. The meeting focused on corporate governance, health and safety (in our view a key proxy for quality of management), community relations, bribery and corruption prevention and climate change. In the meeting, the investors made the following specific requests and followed them up in subsequent communications.

Investor demand	Company response
Disclosure in the Annual Report and Accounts on the way in which the Nominations Committee takes diversity into account, in view of the reluctance to publish a voluntary target.	Agreed.
To introduce an external whistleblowing facility.	Only committed to greater publicising of its internal facility first.
Detailed disclosure on Essar Energy's bribery and corruption policies.	Agreed.
To consider adopting integrated reporting in its Annual Report and Accounts (while not being mutually exclusive from a stand-alone sustainability report).	Will consider but focusing first on alignment with the Account Ability 1000 Assurance Standard for sustainability reporting and the Global Reporting Initiative guidelines on report content (both of which are good practice).
To arrange another meeting focused on corporate governance with the Senior Independent Director present.	Agreed. Essar has since followed up to arrange.
To report injury and fatality groups and targets for the entire company.	Agreed.
To establish KPIs not only for CO <sub>2</sub> but other key emissions and particulate matter from coal-fired power stations including NO <sub>x</sub> , SO <sub>2</sub> , benzene and mercury.	Does not wish to go further than CO <sub>2</sub> at present.

**How Essar Energy performed**

We always welcome the willingness of an executive director to discuss ESG issues at length and all the investors present were struck by the openness of the company to how its performance could be improved. In general, we took away the impression that CSR and health, safety and environment are better resourced and managed than company disclosure would suggest, while acknowledging, as the company does, that some of the greatest challenges lie ahead as Essar Energy massively increases its activities and assets.

There was a difference of views between the investors and Essar Energy on the relevance of future environmental legislation. We had established early in our due diligence that Essar Energy was not using state-of-the-art cleaner coal technology. Essar Energy's position was essentially that the lack of supply, longevity of demand and price sensitivity of power in India means that in any scenario where power supply and environmental concerns face off, the environment loses and that in any case, commercial power purchase agreements allow for incremental costs to be passed through. The Co-operative Asset Management followed up separately with a specific challenge on climate change regulation.

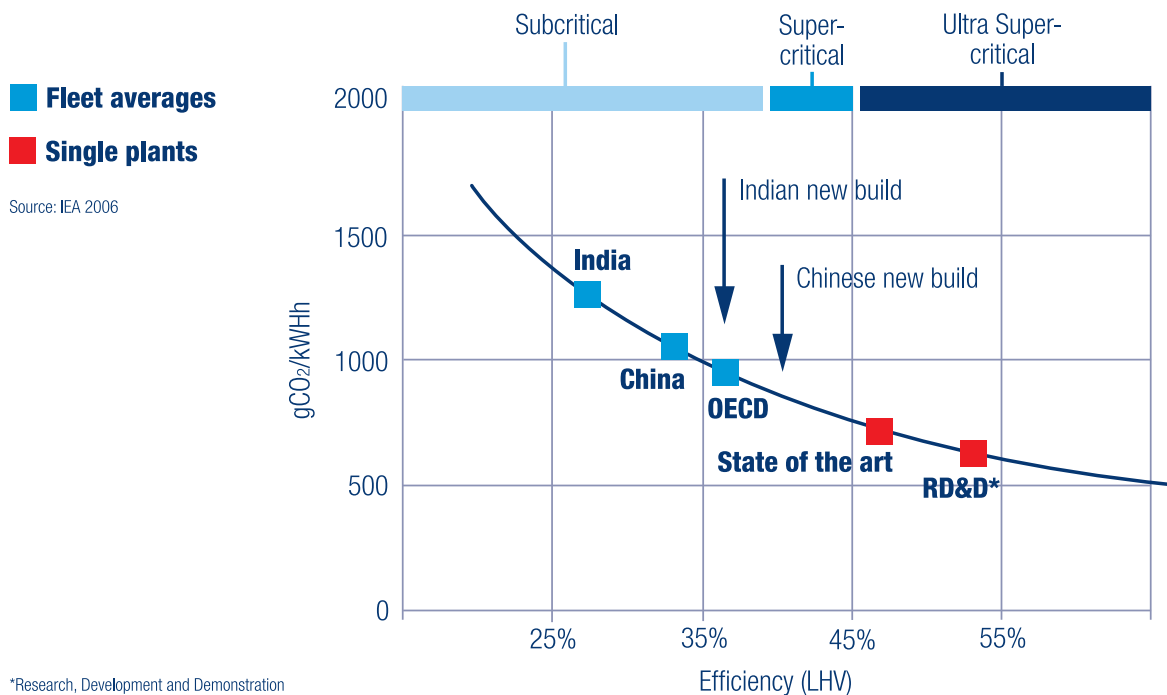
**Changing expectations**

We argued to Essar that just as it would be naive of us to dismiss 'demand trumps all' as a plausible situation (we chose to invest in the Indian growth story, after all), it would also be naive to bank on weak environmental legislation lasting into perpetuity. History is a useful guide to the future here. Economies which have rapidly industrialised since the early 19th century saw their very growth threatened by a lack of clean water and air; this resulted in landmark laws which proved transformative to industry. It is a pattern well-observed that as countries develop an influential middle-class, as the population grows, as urbanisation sprawls and as power (and water) infrastructure is built to be close to population centres, the pollution that yesterday's rural poor had little choice but to endure is seen by tomorrow's urban affluent as an unacceptable incursion on their quality of life.

The coal-fired power plants (CFPPS) Essar Energy is currently building have a life of around 30 years or more: long enough for India's attitude to environmental protection to be completely transformed, including trans-boundary issues like greenhouse gases. Consequently, the net present value of Essar Energy's assets may be less than it was currently assuming. Many oil, gas and power companies now use an internal assumed price of carbon, for example, to assess whether a project will remain economically viable. \$40 per tonne is often heard, taking into account the expectation that the current low price will rise, though we note that research from investment banks has cited prices of around \$100 per tonne needed for serious efforts to decarbonise, incorporating the commercialisation of carbon capture and storage – arguably now the only hope for new coal, in Europe and the U.S. at least.

We flagged that the *Financial Times* reported on 24th October<sup>1</sup> that HSBC, Standard Chartered, BNP Paribas and Credit Agricole are among international financiers of coal-fired generation that have taken it upon themselves not to finance any power plant in emerging markets with an emissions intensity greater than 830g per kilowatt hour (kWh). These are also precisely the banks at the forefront of the Equator Principles<sup>2</sup>, which are aligned to the International Finance Corporation's performance standards which Essar Energy aspired to meet.



Chart 1: CO<sub>2</sub> emissions from coal-fired power stations<sup>3</sup>

Though the figures in Chart 1 are from 2006, we noted that the average figure for an Indian new build was c.1,200g CO<sub>2</sub>/kWh – approximately 50% higher than the ceiling these major banks are using at present to guide their financing of CFPPs in emerging markets. In the absence of CO<sub>2</sub> intensity estimates for Essar Energy’s build-out programme, if the 2006 figure for Indian new build is a reasonable proxy and assuming also that the technology Essar Energy has committed to use would have been commissioned a few years ago, it would appear that these assets would be refused finance from these banks today.

We therefore asked that Essar Energy:

- Agree to publish as soon as possible the expected and actual g CO<sub>2</sub>/kWh of each of its significant assets in relation to this 830g target
- Consider contingency plans in the scenario where most project financiers coalesce around the 830g target in terms of the ability of Essar Energy to a) finance new projects using existing favoured technologies and b) re-finance projects now in the pipeline
- Consider the negotiating power of industrial and wholesale customers to re-negotiate power purchase agreements in a future scenario where they become unwilling to shoulder all the burden of passed-through environmental costs under a new political climate of greater environmental protection
- Explain to shareholders what capacity these assets have to convert, for example, to best-available technologies.

Essar Energy stood by its view that coal was the only realistic option for India, but did not address the issue of threatened sources of finance, noting only its pass-through arrangements. It did, however, agree to commit to publishing the CO<sub>2</sub> performance of each power station, which at least provides investors with the data they need to make up their own minds.

During the course of the engagement Essar Energy’s share price performed poorly. This was mostly due to the government’s failure to grant the necessary licences to allow Essar Energy to clear a forest atop coal blocks (awarded to the company as part of the agreement to build power stations at those locations), after the Environment Minister objected and was subsequently re-shuffled. The delay protracted as the Indian administration froze in a paroxysm of indecision and fear, due more to the recent spate of national corruption scandals, rather than because anything Essar Energy had or had not done. Then, in December, the Vice-Chairman of Essar Group became entangled in a separate corruption scandal surrounding the award of mobile telecom licences (Essar Group adamantly denies any impropriety) and temporarily stood down. The year ended with proposed corruption legislation, the Jan LokPal Bill, in tatters following bitter recrimination between political parties. We exited the shareholding before the end of the year once we felt that the delays presented an unacceptable risk to the company meeting its debt obligations.

### Right idea, wrong degree

So what did we learn? Looking back, we identified the right issues, predicting that Essar Energy’s licence to operate was vulnerable and took what seemed prudent actions in our valuation and engagement. But our ESG discount clearly wasn’t steep enough to account for the extent to which the ESG issues identified, especially the corruption crisis in India, would reverse the fortunes of the company as quickly as they did. The experience has been salutary in that it serves as an almost ideal example of why understanding ESG issues in nature, degree and timing can be indispensable to getting the investment right.

<sup>1</sup> ‘Banks turn up heat on coal-fired financing’, *The Financial Times*, p.19

<sup>2</sup> The Equator Principles provide a framework to help banks manage environmental and social issues in project financing <http://equator-principles.com/>

<sup>3</sup> [http://www.theclimategroup.org/\\_assets/files/Guidance-for-Financing-New-CFPP-TCG-2011\\_1.pdf](http://www.theclimategroup.org/_assets/files/Guidance-for-Financing-New-CFPP-TCG-2011_1.pdf)



### Mutual Concerns

Robert Mugabe's notorious regime in Zimbabwe needs no introduction. There are pros and cons to avoiding exposure versus engaging to effect change within pariah states. We also recognise the impossibility of avoiding the Mugabe regime completely if doing business there at all. In previous years we have engaged with media company WPP about their exposure to Mugabe's propaganda machine. To their credit, WPP swiftly closed its Harare office once it emerged in The Times that one of its associates had been using company resources in support of Mugabe's re-election campaign. We have also discussed with Anglo-American its involvement in a mine in Zimbabwe, where it became clear they had gone to some lengths to minimise support for the regime whilst maintaining operations and employees there.

Old Mutual is the largest financial services company in Zimbabwe and its involvement in the country stretches back 109 years. However, given Zimbabwe's continued bottom quartile ranking in the Transparency International's Corruption Index, not to mention the international sanctions applied against it, we wrote to Old Mutual to highlight our concerns about the risks posed by its exposure to specific activities in Zimbabwe.

The backdrop to this engagement, and our call for Old Mutual to re-evaluate its strategy, is two-fold:

Firstly, the UK Bribery Act and industry-led initiatives (such as the Extractive Industries Transparency Initiative) that it supersedes, recognise that corrupt business environments are bad for business. For instance, the indigenisation policy (that requires foreign companies operating in Zimbabwe to give a majority stake to the indigenous population) instigated by the Mugabe regime creates not only uncertainty over property rights but also the possibility of interference in corporate governance.

Secondly, as the News Corp scandal has demonstrated, in an era of increased transparency, social media and greater awareness of the activities of multi-national companies, both customers and other stakeholders can be moved to re-consider their relationships with businesses.

The aim of our engagement was to gain insight into Old Mutual's assessment and management processes for addressing political and reputational risk, as well as to ask for comment on the appropriateness of some of their specific investments. A couple of examples of specific investments of concern to us are:

- 1) The direct and indirect exposure to the Marange diamond fields (through a company called New Reclamation) which represents up to a fifth of the world's diamond deposits. There are claims of extensive use of forced labour and a recent BBC Panorama documentary alleged the presence of torture camps onsite.
- 2) Old Mutual's investment in Zimbabwe Newspapers Group (Zimpapers): the state-run Herald and Sunday Mail, published by Zimpapers, are widely acknowledged as being instruments of regime propaganda.

The stance we adopted was not to recommend Old Mutual's total divestment from Zimbabwe, but to encourage the company to consider

how it could avoid association with the most egregious aspects of the Mugabe regime, and instead use its influence there for the good of all Zimbabwean citizens.

We welcomed Old Mutual's willingness to address our questions individually and the frankness of their response. We also welcomed the company's decision to review its Code of Conduct in light of the UK Bribery Act and we look forward to hearing about progress in the areas flagged for action. However, it was disappointing to learn that Old Mutual adopts a passive stance towards its investments in Zimbabwe, such as Zimpapers: it appears to allow local, subsidiary asset management businesses wide-ranging discretion on the level of due diligence carried out on the credit risks posed.

Regarding Old Mutual's exposure to the Marange diamond fields, we take no comfort in the company's assertion that it sought and received assurances from the Zimbabwean Government of National Unity that Mbada Diamonds (the joint venture between the Zimbabwean Government and New Reclamation) is operating in accordance with all required standards and regulations. We consider such declarations to be paper-thin without independent, third party assurance. Nor do we take reassurance from the knowledge that the joint venture has been explicitly supported by the Government of National Unity of Zimbabwe and that all requisite approvals were processed prior to the commencement of the joint venture.

We will continue to engage with Old Mutual on their exposure to Zimbabwe as part of our wider engagement on human rights, corruption and exposure to countries whose conduct is considered to be out of line with international norms.

### Improving slaughter standards

Most people accept that if we are to continue to use and slaughter animals for human benefit, we should at least avoid cruel and inhumane treatment while they are alive. One fundamental change which is gaining momentum as beneficial to both animal welfare and the quality of the carcass is Controlled Atmosphere Killing (CAK). The drive towards greater use of CAK is being led by the UK and Europe, however it is also an approved slaughter method according to the U.S. Department of Agriculture (USDA). CAK is currently used to kill 75% of turkeys and 25% of chickens in the United Kingdom and 10% of all fowl in the European Union.

Using the CAK method, birds are placed in a cabinet or chamber where the oxygen is removed and slowly replaced with non-poisonous gases such as carbon dioxide or argon gas that render the birds unconscious while they are still in their transport crates. As a result, unlike other traditional techniques, the birds are not distressed or hurt prior to slaughter.

With CAK, workers do not handle live birds, so safety is vastly improved. Lights can be kept bright, the air remains clean, and workers do not need to struggle with distressed birds. The Canadian Poultry Magazine reports that post-CAK implementation there has been a significant decrease in worker personal injury compensation claims and employee turnover rates. The profit comes not from charging customers a premium for birds raised (as there will always be a market for cheaper meat) but because of lower amounts of discarded carcasses.



Modifications to existing infrastructure are required before slaughterhouses can transition to using the CAK method. This invariably raises the question of return on investment periods. Several US-centric studies have highlighted that due to increased revenue from higher quality meat and lower operating costs, the initial costs of switching to a CAK system can be recouped in only a year, depending on individual requirements. For instance, a slaughterhouse with the capacity to slaughter 128,000 birds per day (many in the US process far more than this) can earn an additional \$1 million to \$1.3 million in profit annually from improvements in meat yield once the initial costs of the CAK system are recovered.

One company which has been the recipient of several shareholder resolutions urging uptake of CAK implementation is the second largest

poultry producer in the US, Tyson Foods. Tyson has 40 processing plants that slaughter over 2 billion chickens a year and supplies household names such as Kentucky Fried Chicken. In response to shareholder resolutions, filed as far back as 2005, Tyson's management have stated that "the company presently plans to continue monitoring new technologies and, where and when appropriate, taking action to further the humane treatment of all animals in our supply chain." However, due to the lack of positive action on this topic to date, Tyson now occupies a laggard position compared to US peers such as Ruby Tuesday, Safeway and Costco.

We will be engaging global companies on the uptake of CAK in the near future.



## Window of opportunity for fishing reform in Europe

It is widely acknowledged that Europe's Common Fisheries Policy (CFP) lacks rigour, is ineffective in helping its intended beneficiaries (sea life and the fishing industry) and is simply not fit for purpose. The state of the marine waters within CFP's jurisdiction backs this up with current concerns centring on the extreme degradation of our seas by over-exploitation, pollution and climate change. This is causing adverse changes in the chemistry of the ocean, with loss of marine life, habitats and ecosystems. Despite amendments to the policy in 2002, the methods by which European fisheries are managed are still failing, resulting in hugely depleted fish stocks and often low economic returns for the fishing industry.

In 2011 the European Commission's proposal for reform of the CFP was published. As investors with exposure to companies involved all along the fisheries supply chain, we want to ensure our companies are not associated with negative reputational risks and have robust, sustainable sources of raw produce.

On the back of the reforms of the CFP, and to gain a greater insight into how this issue affects our investee companies, we met with Chris Davies, a Minister of the European Parliament (MEP). He is very much at the centre of the debate and is a founder of the cross-party Fish for the Future group in Brussels.

Until the adoption of the Lisbon Treaty in 2009, the design of the CFP has been controlled solely by the Council of Ministers in Brussels with the European Parliament having no influence over CFP content. Post-Lisbon, the European Parliament and its MEPs are now partners with the Council of Ministers in the development of the fisheries policy.

Aside from the high profile topic of discarded by-catch, one of the key messages we believe should be fed into the reform is the urgent need to rebuild fish stocks to somewhere near historic levels. This could be done by creating marine reserves centred on the spawning and nursery grounds of fish stocks.

Buoyed by the importance of this once-in-a-decade opportunity for reform we arranged a number of meetings with other stakeholders working on the topic. The opportunity to shape the reforms will form a focal point in our sustainable fisheries engagement for the near future.



**Over 85% of assessed fish stocks in European waters are fished to maximum potential or are over-fished<sup>4</sup>.**

<sup>4</sup> The State of World Fisheries and Aquaculture, Food and Agriculture Organization, 2011

# Section 2 **Corporate Governance**



### Diageo AGM

As part of our 'stewardship' responsibilities we use our voting power to express dissatisfaction whenever we have corporate governance concerns. We also follow up by writing directly to the company, explaining our reasons when we have not supported a resolution. In Diageo's case we have had to do this for eight consecutive years, finding ourselves unable to support the remuneration report across that period. Although a relatively small investor in the context of Diageo's highly dispersed share register, our customers still have an £83 million investment in the company. Moreover, we had grown increasingly frustrated by the lack of formal response from the company during these eight years.

This year our concerns over remuneration were such that we decided that a more direct form of engagement was appropriate to make sure our message was heard. Therefore we attended Diageo's AGM to make a statement directly to the Chairman and to hand deliver our letter and analysis directly to the Chairman of the Remuneration Committee. This way there could be no mistake.

Here's an extract from the statement we gave at the AGM:

"We've long-held concerns over remuneration, only this year the high level of award vesting under the share schemes for average

performance; the lack of disclosure justifying clockwork bonus awards; the consistently underwhelming nature of the EPS targets next to market consensus means our confidence in the Remuneration Committee has been badly shaken.

We were alarmed to find that a significant change to the leaving provisions for the CEO under the performance share plans (PSP) share grants was omitted from the shareholder consultation process during the year. Under this change the award can vest in full even if our Chief Executive Mr Walsh were to leave the company before the end of the performance period, even some years before. We find this unacceptable. I therefore ask that the Remuneration Committee review this proposed change and further, that we receive a formal response to our letter that I have brought hand-delivered to you today."

As it turned out other shareholders must have shared our concerns as the proxy results returned the highest 'oppose' level in the history of the company for the acceptance of a remuneration report. In total 20% of shareholders opposed the report with a further 26 million shares abstaining - a milder form of dissent. While we were not wholly convinced by the response received at the AGM, the company has now resolved the error leading to the correspondence failure and comprehensively responded in detail to our letter. We are now able to follow up with a less confrontational engagement on the issues.



Concerns we could bottle no longer.



**Market reform and corporate governance in focus.**

## Consultation Fever

We made detailed submissions to a record five government and industry consultations during the quarter. All related to reform of governance systems within companies as well as the governance of the economic system itself. Many issues can only be tackled by addressing the often dysfunctional relationship between those with a critical role in delivering financial benefits to the economy and to citizens; namely pension funds and employers and the asset managers who intermediate; investing in the latter on behalf of the former. It's no coincidence that the number of consultations has risen substantially in the last few years in the aftermath of the financial crisis, part of the collective soul-searching exercise induced by a crisis in capitalism. Our submissions, taken together, set out our vision for lasting and meaningful reform of the whole market system with an emphasis on practical implementation and our experiences as investors.

The five consultations were:

### 1) Department for Business, Innovation and Skills (BIS): The Future of Narrative Report - Consulting on a new reporting framework

Companies devote significant resource to drafting and publishing external reports such as Annual Report and Accounts and Corporate Responsibility reports with the aim of painting a picture of the current, as well as potential prospects of the company. This time last year we summarised our response to the government consultation on the Future of Narrative Reporting. BIS recently followed up that consultation with a further set of questions seeking views on government plans to make narrative reporting simpler and more focused. It also included proposals to make the regulatory framework clearer for companies and easier for investors to locate the information they need.

### 2) BIS: Executive Remuneration: Discussion Paper

The Paper put forward wide-ranging proposals on linking executive pay more closely to company performance and tackles more broadly the remuneration setting process. Some of the more radical reform options under consideration included a binding vote for shareholders to

sign-off pay, employee representation on the remuneration committee, shareholder representation on the nomination committee, and an employee vote on executive pay.

### 3) The Kay Review

Professor John Kay, appointed by the Secretary of State for Business, is leading a review into, and seeking opinion on, how well equity markets perform in their core functions of:

- a) Enhancing the performance of UK companies by facilitating investment and enabling effective governance and decision-making in support of long-term profitability and growth;
- b) Enabling investors to benefit from this corporate activity in the form of returns from equity investment.

### 4) The FTSE UK Index Series User Consultation on Free Float Thresholds

A free float is the number of shares which can be freely traded and are not owned by, for example, a company's founding family. This consultation sought views on the minimum proportion of free float that a listed company should have. One of the reasons this topic is being given attention is the presence of several large companies in the FTSE100 with free floats of less than 25%, such as Essar Energy, Glencore and Eurasian Natural Resources Corporation – which was at the centre of a governance scandal recently.

### 5) The Global Reporting Initiative's (GRI) Public Comment Period

GRI is a not-for-profit organisation that promotes a single set of key performance indicators (KPIs) for companies worldwide to use in their sustainability reporting. The GRI framework can be helpful, steering companies towards more comprehensive reporting on material issues. This round of consultation focused on integrated reporting (i.e. integrating sustainability reporting into a company's annual report), sector-based reporting and emerging topics for inclusion in GRI's reporting framework.

### Recurring themes and some of our views

#### 1) A disproportionate focus on the short term at the expense of the long term

Covered in:  
The Kay Review  
BIS - Future of Narrative Reporting  
BIS - Executive Remuneration

In the market:

- Previously, we have examined how those involved in equities markets are, deliberately or otherwise, incentivised to act in a short-term manner. To address market short-termism we need to get to the root of capital allocation – i.e. by evaluating the way in which pension schemes and investment mandates are managed. We advocated further review of UK pension scheme governance and the design of investment mandates and called for the explicit inclusion of stewardship responsibilities within investment mandates.
- In our view, prevailing interpretations of fiduciary duty are stuck in the past. We believe that trustees are misinterpreting their 'duty of prudence' (i.e. responsible financial management) and are focusing excessively on short-term investment performance. We pressed strongly for an updated, legally sound definition of fiduciary duty.

In executive remuneration:

- Research indicates that companies that tie larger proportions of executive remuneration to share price performance are more likely to manipulate earnings per share (EPS). What started as an intention to align interests by internalising the principle of shareholder value has encouraged short-term management decision-making. This is compounded by termination provisions for executives that effectively allow shares to vest or be replaced, even in the event of failure. We called for accumulated remuneration shares to be held for a period of time beyond an executive's departure from a company and for contractual leaving provisions to be approved by shareholders, as separate share schemes already are.
- We believe there is a strong case for longer-term horizons for performance share grants for executives; both for performance periods and holding requirements. We therefore expressed our preference for the standard period to increase from three to five years to better reflect the capital investment cycle at many companies.

In reporting:

- We noted that in corporate reporting we would welcome a clear explanation of long-term as well as short-term opportunities and risks for our investee companies, where they exist, at a strategic as well as managerial level: e.g. product ranges that address upcoming regulations ahead of the competition.
- There is robust, empirical research demonstrating that shortened company reporting horizons encourage short-term thinking and capital allocation from management. We welcome consideration by the Kay Review of removing the interim reporting requirements for companies under the amended Directive on Transparency Obligations.

#### 2) What gets measured gets managed

Covered in:  
GRI – Integrated Reporting  
BIS - Future of Narrative Reporting  
BIS - Executive Remuneration  
FTSE Free Float

In remuneration:

- At the time of writing David Cameron has thrown his weight behind the BIS proposal that the current advisory vote on executive remuneration should become a binding one. We think that if there is a workable way of implementing binding votes then there is merit in this as a principle though more as an inducement for shareholders and companies to engage beforehand and reign in payment for failure. Currently, shareholders are often involved only at the final stage once plans have been substantially completed. More formal initial input from shareholders early on in the process would help align them with the underlying rationale of changes to pay and help them to feedback on proposals more effectively. We think a binding vote would make this type of early engagement more important. However, the proposal is held back by the valid concern that it is not obvious what the legal and practical consequences would be when such a binding vote results in the defeat of that resolution. What next?
- We supported many of the BIS proposals to simplify remuneration reporting. A significant aspect of this would separate out key information and narrative into a 'Strategy Report' from some of the necessary but dense information that would become part of an 'Annual Directors' Statement'. We believe this will enable closer scrutiny as to the degree of strategic alignment and whether awards reflect performance.



In the market:

- Our stance on the proportion of shares in a company which should be freely available to be bought and sold (the free float) was that companies hoping to join benchmarks such as the FTSE100 should be made to ensure that at least half their shares can be freely traded both to ensure that shares are liquid and to improve protection for minority shareholders.

In reporting:

- In our view, integrated reporting represents best practice. It helps to set sustainability issues within the context of core business strategy. Companies that use integrated reporting are often those with the most sophisticated understanding of sustainability and the implications for their business. The identification of environmental, social and governance (ESG) issues that are considered to be material to the company and sector should be included in the Annual Report and Accounts (ARA) i.e. those issues with the potential to affect a company's operation, financial health or perception by critical stakeholders in both the short and long term.
- Independent verification and assurance of material data is highly desirable, including relevant sustainability data.

**3) Encouraging sustainable business practice**

Covered in:  
The Kay Review  
BIS - Executive Remuneration

- We consider integrated reporting the next logical step on from piecemeal disclosures, for example, mining firms citing their Lost Time Injury Frequency Rate and fatality rates alongside production volumes within the Annual Report and Accounts. We also encouraged GRI to develop guidance for companies that are keen to take an integrated approach.
- In our consultation responses, we conveyed the need to ensure that remuneration structures foster a long-term approach by management to enable sustainable profits. This is an increasing area of focus for us. Making sustainability part of how people are paid can play a role in driving performance balanced by good risk management. In this regard we are leading a group of global investors to explore with companies the development of best practice principles.

**4) Transparency and disclosure**

Covered in:  
FTSE Free Float  
BIS - Future of Narrative Reporting  
BIS - Executive Remuneration  
GRI – Integrated Reporting

On gender:

- Our strong preference is for data on gender balance to be broken down by management hierarchy. In the case of companies with global operations a regional split would be desirable. We gave examples of companies who do this in an innovative way which we find informative and easy to digest.
- We highlighted how our recent work on gender in the boardroom has led us to explore the issue of pay disparity in its widest sense. We offered qualified support to the BIS proposal that “quoted companies should also be required to publish the ratio between the median pay of their workforce and that of the CEO”. Furthermore, we believe this recommendation sits well with the UK Corporate Governance Code's guidance in respect of the need to be sensitive to pay and conditions across the company when determining remuneration.

On remuneration consultants:

- We believe there is a strong case for increasing transparency around remuneration consultants and their relationships with companies, i.e. greater disclosure on consultants' mandates, remits, controls on their capacity, conflicts of interest, fees and contact with senior management.

We will report back on the conclusions of these consultations in future editions.



## Olympic Games

The majority of infamous cases of corporate blow-ups stemming from poor governance, such as Enron and Worldcom, are uncovered after whistleblowers draw attention to misdoings. However, the recent accounting scandal that hit Japanese electronics company Olympus added a twist to the format. No less than the Chief Executive, Michael Woodford, became the whistleblower by highlighting a raft of suspect payments revolving initially around vastly inflated advisory fees paid on the back of the acquisition of Gyrus. He was subsequently sacked by his own board. Further investigations followed and many more accounting cover-ups floated to the surface.

The firm was told by the authorities to revise five years' worth of annual accounts. This uncovered a massive discrepancy in net assets which, after revisions, came in ¥105 billion lower than previously announced and now reach a meagre ¥46 billion. Equally, last year's net profit was halved to ¥3.9 billion.

We recently became members of the well-respected Asian Corporate Governance Association (ACGA). One of our first engagements under the umbrella of the ACGA was, unsurprisingly, directed at Olympus.

While the matter is still developing on almost a daily basis, enough evidence has been brought to light to paint a very bleak picture of governance at Olympus. We have found it disappointing that, against the backdrop of such blatant disregard for good governance and basic standards of accountability, Olympus has taken so long to take steps to address the ingrained problems.

For example, an Extraordinary General Meeting (EGM) that would allow shareholders to vote on a new batch of directors has not been scheduled until March or April next year. Indeed, only four of the directors implicated in the scandal have left thus far. Whilst we are mindful of the pitfalls of a mass resignation of the board, given the unquestioned group-think and the failure of directors to run the company in the best interests of shareholders, we have no confidence in the remaining board members and will vote the small number of shares we hold accordingly when the time eventually comes.

### Conflict of interest removed at mining company

At a prominent FTSE100 mining company we expressed concern in 2010 over the role of a non-executive director on the remuneration committee of the board. As he was also the CEO at an important supplier of services to the company, we deemed his role on the committee to be inherently conflicted; he would be influencing the pay-out of an executive that would, in turn, be deciding on the award of material contracts to his company. Although the director was not standing for re-election at the 2010 AGM, we told the company that we would not be able to support this kind of arrangement in the future and would therefore feel forced to oppose his re-election in 2011, were he to stand. The company acknowledged the nature of our concern, one that was no doubt shared widely by other shareholders, and prior to the 2011 AGM the director stood down from the board. The remuneration committee is now comprised fully of independent directors.



Light finally seen on conflicts of interest.



## Section 3

# Murdoch Myopia – Short-sighted governance

The *News of the World* (NOTW) itself became world news during 2011 when what was initially portrayed as an isolated incident of phone hacking snowballed into an unprecedented police investigation into the paper's journalistic practices. It was also an example of flagrant governance failure. While much soul-searching followed on the role of media in society, unsurprisingly what confidence lingered in the corporate governance arrangements at NOTW and its parent company, News Corporation (News Corp.), evaporated overnight. The reputations of those implicated have also faced scrutiny, not least James Murdoch's. As Chairman and Chief Executive of News Corporation Europe and Asia, and with doubt surrounding his knowledge of hacking practices at NOTW, shareholders have questioned his suitability on the board of British Sky Broadcasting plc (BSkyB).

This formed a flashpoint at the recent BSkyB AGM and was heavily trailed in the media as other institutional investors voiced their concerns. As a holder of 0.03% of BSkyB in passive, tracker funds (partly owing to long-standing corporate governance concerns which we explain on the next pages), we thought it better for major shareholders to take to the microphone. But based on over 13 years of our own governance analysis and engagements with BSkyB and News Corp., we believe that there were more than adequate warning signs for investors. Therefore, we thought it would be timely to set out our engagement track-record with BSkyB, and use the company as a case study to show how we incorporate governance risk into investment decisions.

### Tackling the Murdoch Empire

We have had consistent and long-standing concerns over the governance arrangements at BSKyB. These are well-documented and relate to the concentration of power via News Corp's share ownership (they hold 40% of BSKyB shares) and its dominance of the BSKyB board. In this context minority shareholder interests are disenfranchised and are at risk of not being protected by sufficient independence on the board. This has been reflected in our proxy-voting going back to 1999, having never supported, among others, the remuneration report, the re-election of James or Rupert Murdoch, or the re-election of any other News Corp. representative on the board. Any time we do not support a resolution we send a letter to the company setting out our rationale. Therefore, we have also sent BSKyB some 13 letters over consecutive years expressing in detail our concerns. As early as 2002 we attended the AGM of BSKyB to question the level of independence on the board and excessive remuneration.

Our records also show that although we have only ever held News Corp. via third-party managed funds, in the years that we have been able to exercise voting intentions we have abstained or opposed 32 resolutions

from 2000 to 2010 despite only holding the company for six years across the period. 78% of those resolutions related to us opposing directors we have long considered non-independent for a range of reasons and thus serving to insulate management from accountability. Notably, in 2010 we supported a shareholder resolution calling on the board to establish a Human Rights Committee with "the responsibility to review and approve all policies and actions taken by the Company that might affect human rights observance in countries where it does business, or where its products and technologies are being used".

*"We have voted against the Murdoch dynasty at both companies for 13 years and spoke at the BSKyB AGM in 2002. To their credit BSKyB has engaged constructively with us on environmental and social issues – but neither company has on corporate governance."*

**Abigail Herron, Corporate Governance Manager.**

### Internal Memo: Attendance at BSKyB AGM 2002

The meeting was well attended; however the majority of the audience were BSKyB employees. Rupert Murdoch, the Chairman, opened the meeting and presented the results for the three months ended 30 September 2002. He then opened the floor for questions...

The Co-operative then asked: 'Mr Chairman, I am a representative of the Co-operative Insurance Society. We are concerned at the lack of alignment of executive pay to performance...

The Co-operative recommends that the remuneration practices of your company are immediately overhauled, to incorporate a more significant proportion of pay linked to performance, to align directors' interests with that of shareholders so that reward is for performance and value added over the long term. Furthermore, disclosure should be improved to enable shareholders to assess the appropriateness of the incentivisation packages offered to directors.

The Co-operative voted against the report and accounts, against the changes to the articles of association and to increases in fees for non-executive directors and against the re-elections of the Chief Executive and 6 non-independent Non-Executive Directors.

**How did we vote at the 2011 AGM?**

**Re-election of James Murdoch as Chairman:** We have always been clear that allowing a representative of the controlling shareholder to chair the board undermines the rights of minority shareholders, even more so since News Corp. has tried to acquire BSkyB. Therefore, we have consistently opposed this arrangement, whether for Rupert or James Murdoch, and did so again at the 2011 AGM. There is also the issue of character and competence. Revelations surrounding malpractice at News International, a prominent subsidiary under James Murdoch's management at News Corp., have demonstrated either poor judgement or a striking lack of operational scrutiny. Either way, we believe it has become an unnecessary distraction for BSkyB.

Based on our calculation of the voting by independent shareholders only, i.e. when the News Corp holding is removed, an unprecedented 44% of shareholders either opposed or abstained on James Murdoch's re-election as chairman. This is an untenable situation and demonstrates that he no longer has a mandate from shareholders.

**Re-election of other News Corp director representatives:**

Consistent with our voting policy, where there is insufficient independence on the overall board we oppose non-independent directors standing for re-election. Therefore, we opposed three further News Corp. representatives as well as two other non-executives not considered independent for separate reasons.

**To adopt the Remuneration Report:** We have conveyed various concerns with the company's remuneration framework over the years and in 2011 many issues remained unresolved. Aside from this, we expressed concern over the use of excessive retention awards. In practice, such awards have been unsuccessful in their stated aims and, in our opinion, serve to undermine the desired incentive effect of existing long-term share grants.

**The News Corp. connection**

While such structural governance frailties at BSkyB have lingered for some time they had never manifested in operational failings or transcended the board room into negative public sentiment leading to detrimental financial performance. However, with News Corp. our governance concerns significantly worsen. The company is seen as having among the worst governance of all the global conglomerates. Despite now only possessing an overall holding of 12%, the Murdoch Family Trust retains nearly 40% of the voting power due to a dual share structure. The News Corp. board is loaded with directors either commercially compromised, with familial links or who lack independence due to tenure. Failed corporate governance has recently led to a series of lawsuits filed by shareholders. Given that News Corporation's subsidiaries and affiliated companies like BSkyB (whether wholly-owned or not) are run in very close synergy, we must consider the upstream governance issues. In other words, one cannot frame the BSkyB investment risk without ultimately including News Corp. in the picture.

The 'crocodile in the water' recently snapped in relation to the News of the World hacking scandal. While BSkyB continues to have such a tangible link to News Corp., whether via ownership or board composition, we consider there to be a material risk that shareholders will be further impacted by the controversy.

Due to developments in the government and police investigations into phone and computer hacking, we consider James Murdoch's continued capacity as chairman of BSkyB to be untenable.

**What are the key investment risks?**

Specifically, the equity risk represented by James Murdoch's continued tenure and the News Corp. connection relates to:

- a) Exposure to further revelations that implicate BSkyB more directly, for instance police investigations have now extended to computer hacking:** given the close synergy with News Corp. operations there is a risk, as yet unfounded, that Sky News journalists become implicated. While Sky News represents a marginal part of the BSkyB investment case (News Corp. were willing to sell it to get approval for a BSkyB takeover), there is no doubt that any direct Sky News link to hacking would directly sour BSkyB's wider reputation and contribute to greater focus on the Ofcom 'fit and proper' test (see box on next page). Aside from this, greater risk may relate to recent accusations that phone hacking may have been co-ordinated to further BSkyB's commercial interests<sup>5</sup>.
- b) BSkyB failing the 'fit and proper' test required by the media regulator, Ofcom, for broadcasting licence holders:** there is much debate about what would constitute a breach of this test and to date the Ofcom line has been to take no action that may prejudice investigations by the police. However, they have also stated, "we are writing to the relevant authorities to highlight our duties in relation to 'fit and proper' and would like to know of any further information which may assist us in the discharge of our own duties."
- c) Direct negative commercial consequences in light of reputational concerns:** In August, the State of New York rejected a \$27 million educational technology contract with a company in which News Corp. hold a 90% stake, citing concerns about the allegations of misdeeds at News Corp. Albeit not a wholly owned subsidiary, given that BSkyB is controlled by News Corp. we cannot discount similar negative consequences, particularly if further allegations emerge.
- d) Boardroom distractions and uncertainty lead to key management departures to competitors:** in other examples of ownership and boardroom unrest, uncertainty has gradually infected management, operational performance and ultimately retention. If high-profile members of the management team begin to seek new pastures this would be a red flag for our investment case and would have implications for valuation. For example, we factor in the incumbent team's reputation for successfully negotiating with regulators in our margin projections. This makes management continuity crucial, something increasingly at risk from the News Corp./BSkyB nexus. It was telling that the board were required to award Jeremy Darroch, the CEO, approximately £2.1 million worth of additional shares as a "retention award" to retain his services through the uncertain period, despite such measures usually failing to achieve their aim.

<sup>5</sup> MP Chris Bryant alleged that the second most hacked individual was the Secretary of State for Culture, Media and Sports, Tessa Jowell, who had responsibility for many things that directly impact BSkyB's commercial interests, such as the law on broadcasting, the EPG (electronic programme guide) and Premiership football rights.



### What do we know about ‘fit and proper’?

Ofcom will not grant a licence to a broadcaster unless they are satisfied that they are ‘fit and proper’. Unfortunately, the Broadcasting Act 1990 (where this requirement originates) provides little explanation or guidance on the term. In the absence of hard and fast criteria, the Ofcom ‘Change of Control Notification’ application form provides some kind of steer. Under the ‘Fit and Proper Criteria’ heading, it asks whether any director or shareholder has ever had a criminal conviction or civil penalty. There is also a focus on regulatory mismanagement by the company. For instance, another application form - this time for the licence to broadcast on satellite or cable - enquires about previous regulatory infringements. From this we deduce that a regulatory breach alone could result in Ofcom revoking a broadcaster’s ‘fit and proper’ status.

While this regulatory mêlée is by no means clear, it does appear to capture directors and major shareholders, and ultimately potential owners, thus acting as a significant contributor to the News Corp. offer withdrawal.

### How do we make sure we pay the right price for BSKyB’s shares?

**1) News Corp. offer withdrawal:** although they did not issue a reason for the decision, following events surrounding the phone hacking scandal at News International and the increased scrutiny from the government that followed, News Corp. decided to withdraw its offer to acquire the remaining BSKyB shares that it did not already own. Based on our analysis of the ‘fit and proper’ status we believe this would have been a major factor in their decision. The first governance-related question on valuation (i.e. the right price to pay for the shares) therefore has to be whether the culmination of risks relating to the phone hacking scandal and the ‘fit and proper’ designation removes the possibility of a premium from a News Corp. offer.

All evidence suggests a very low probability of News Corp. coming back to the table (for at least a few years) and even if they did (and Ofcom were satisfied from a licence perspective), it seems almost certain that it would be subject to a Competition Commission review. Given News Corporation’s holding, the possibility of another acquirer coming to the table is highly unlikely.

**2) Cost of capital based risk:** BSKyB itself is one step removed from some of the operational governance failings seen at News Corp. While there is the risk of similarities in the underlying management culture between the two companies, we should not ignore evidence on the ground that indicates a) the independent directors have behaved correctly in their negotiations with News Corp. through the acquisition discussions and b) operational management have a strong track record, particularly in protecting their position in the face of increasing scrutiny from the regulator.

Additional considerations to be taken into account in weighing up the News Corp./BSkyB situation are that much of the negative impact on performance at News Corp. has been derived from poor governance that is linked to a lack of capital stewardship and failing accountability and control through the conglomerate structure. BSKyB is not a conglomerate, is operationally less complex, and there appears less risk of poor capital stewardship, unlike at News Corp. which has carried out a number of merger and acquisitions in recent years. In a sense, therefore, a large proportion of the risk relates to the propensity for News Corp. as a shareowner and holder of multiple board seats to undermine the operational record of BSKyB.

On capital management, some will point to the purchase of ITV shares that was subsequently reversed by the Competition Commission. This resulted in a big non-cash impairment charge to the tune of £800m in the 09/10 accounts and the forced disposal of half of the holding. This caused an absolute loss of circa £350m. However, many still consider the controversial move successful (and money well spent) in blocking what could have been a transformative merger for a key competitor. Likewise, BSKyB’s ‘bigger picture’ foresight to make long-term investments in film content deals, reinvigorate Premier League coverage and invest in set-top technology, are all initiatives keeping the company ahead of the curve today.

Weighing this up next to the extreme backdrop of News Corp., the ‘fit and proper’ test and James Murdoch remaining as Chairman, we isolate two key governance risks in our overall discount rate, in plain terms the likely threat to future cash flows<sup>6</sup>:

- the risks outlined above relating to News Corp. share ownership, the ‘fit and proper’ test and the continued tenure of James Murdoch; and
- the risk of continued lack of protection for minority shareholders reflected by the lack of overall independence on the Board as a whole (due to the News Corp. representatives) and increasing the risk that underlying failures will not be confronted and disclosed.

By increasing what we judge to be the real cost of capital in this way to reflect the governance risks it means we are discounting the projected future cash flows of the business at a slightly higher rate, i.e. it will cost more to finance those future revenues. This means that the present value we can attribute to those cash flows is decreased. When we overlay the governance discount it translates to a material reduction to our in-house ESG integrated valuation of the business. To put this into context, the degree of change is comfortably the difference between whether the company currently represents a good investment or not; or in other words, our valuation of the business is decidedly below the rest of the market. And hence we have not taken an active position in this company.

This is the governance risk we have factored in to our valuation as matters stand, ‘our holding position’. But there could be many twists and turns over the next one to two years that we need to consider as part of the investment case.

<sup>6</sup> We have refrained from publishing our proprietary quantitative governance discount as this is commercially sensitive.





**Make sure water's in the boardroom.**

## Section 4 **Recent Developments**

### **CDP Water: one year on**

The Co-operative Asset Management is a signatory to the Carbon Disclosure Project (CDP). The Project works on behalf of signatory investors to encourage the world's largest companies to disclose data on their carbon emissions and, in recent years, on water use. The initiative works primarily on a request basis: companies are contacted by CDP and are invited to submit data. CDP makes this information available on its website, providing investors, policymakers and NGOs with a broadly comparable data set for all participating companies.

Back in December 2010, we wrote to a number of companies that had declined CDP's invitation to submit water-related data: Apple, Centrica, The Coca-Cola Company, E.on, EDF Energy, Lafarge, Royal Dutch Shell, Scottish & Southern Energy, Talisman and Total. Although water scarcity poses significant business risks and opportunities, corporate action on water has been fairly sluggish and typically lags behind carbon management. So we

were, and remain, keen to see investee companies take a proactive stance and disclose information in line with CDP's water reporting framework.

Many of the companies that we contacted committed to participating the following year, i.e. CDP Water Disclosure 2011. The results were published in November and of the ten companies we contacted, we were pleased to see that six have indeed submitted water data (Centrica, The Coca-Cola Company, E.on, EDF Energy, Lafarge and Total). Of the rest, we have reported on our engagement with them in previous issues. But to summarise, we received a detailed response from Royal Dutch Shell on their approach to water management; Apple continues to decline the invitation to participate; Talisman was considering participation but decided against; and Scottish & Southern Energy did not respond, but were not targeted by CDP in the same way as the other companies, due to their size. So a mixed bag, but some progress at least. Water continues to be a key environmental theme for us, and we will continue with our engagements on this topic in 2012.

### **National Employment Savings Trust**

The Co-operative Asset Management is delighted to have been selected as the winner by public tender to provide responsible ownership services to NEST (National Employment Savings Trust). NEST is the low-cost pension scheme set up as part of a broader programme of workplace pensions reform being introduced by the UK government. It is a defined contribution occupational pension scheme and will be a qualifying scheme for auto-enrolment purposes under the Pensions Act 2008.

NEST launched a year ahead of employer duties in July of last year with low volumes of volunteer employers and is anticipated to be one of the largest pension schemes in the European Union.

NEST aspires to a world class responsible investment approach and believes responsible investment supports long-term value, reduces risk and supports better member outcomes.

The Co-operative Asset Management, with assistance from the proxy voting agency Manifest, will assist NEST to develop and deliver its policy on responsible investment and ownership, by providing expertise in the following areas:

- Policy development, advice and reporting
- Engagement advice and delivery
- Stakeholder relations management
- Proxy voting advice and delivery.



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