REPORT TO: **SUPERANNUATION INVESTMENT SUB-COMMITTEE OF THE POLICY AND RESOURCES COMMITTEE - 28 NOVEMBER 2011**

REPORT ON: **SOCIALLY RESPONSIBLE INVESTMENT - SIX MONTHLY REPORT**

REPORT BY: **DIRECTOR OF FINANCE**

REPORT NO: **527-2011**

1 PURPOSE OF REPORT

This report reviews the progress by the Fund Managers regarding the positive engagement Policy on Environmental, Social and Corporate Governance approved by the Sub-Committee on 17 November 2008.

2 RECOMMENDATIONS

The Sub-Committee is asked to note the information contained within this report with regard to the activities of the Fund Managers during the six month period ended 30 September 2011.

3 BACKGROUND

On 17 November 2008 the Sub-Committee approved a revised Policy on Environmental, Social Governance. This policy recognises the over-riding fiduciary duties but encourages the managers to engage with companies. They are requested to summarise this engagement activity quarterly. The key areas continue to be Employee Care, Human Rights, Sustainability and the Environment.

4 ALLIANCE BERNSTEIN

Alliance Bernstein's latest activity is shown at Appendix 1.

5 BAILLIE GIFFORD

A summary of recent engagement activity is shown at Appendix 2. This shows the wide range of topics covered and the diversity of companies approached.

6 FIDELITY

Appendix 3, shows various examples of issues Fidelity have considered in the last quarter.

7 OVERALL CONCLUSION

The managers have continued to develop their strategy in this area and link more closely with the long-term effect on share value.

The fund is still committed to following the United Nations Principles of Responsible Investment.

8 **POLICY IMPLICATIONS**

This Report has been screened for any policy implications in respect of Sustainability, Strategic Environmental Assessment, Anti-Poverty, Equality Impact Assessment and Risk Management.

The Fund's policy on Socially Responsible Investment requires its investment managers to engage with companies on Sustainability and the Environment and Employee Care and Human Rights.

9 **CONSULTATION**

The Chief Executive and Depute Chief Executive (Support Services) have been consulted in the preparation of this report.

10 **BACKGROUND PAPERS**

None

MARJORY M STEWART
DIRECTOR OF FINANCE **17 NOVEMBER 2011**

Taking an Active Role in Executive Compensation

Compensation Principles

- As much compensation as possible should be variable: certainly more than 50%
- Variable compensation should be linked to the multi-year performance of the business
- Payments to be linked to achievement of specific, quantifiable, stretching business objectives for which audited data are in the public domain
- Senior executives should hold company stock equivalent to a significant multiple of their annual compensation
- Remuneration committees must be demonstrably independent to ensure adequate oversight
- Automatic compensation increases linked to comparator analysis are inflationary and to be avoided

Our Approach

- We vote proxies actively on our clients' behalf following these policies
- We engage with companies to understand their approach to pay, and to make our concerns clear where appropriate

Examples in 2011

- We voted against the remuneration policy of a Dutch insurer due to poor disclosure of performance criteria
- We voted against the remuneration report at a major UK bank because proposed performance criteria did not properly align management interests with those of shareholders
- We voted against the remuneration report at a UK publishing company because we considered proposed increases in compensation to be excessive relative to performance

Emerging Markets Governance Actions 2011:

- We voted against the election and remuneration of directors at five separate Brazilian companies as they company failed to provide sufficient details for an informed decision.
- We voted against the remuneration of directors at a Russian energy company, and a South Korean metals company, as we considered compensation to be excessive
- We voted against the election or re-election of directors at a number of companies due to insufficient background information, inadequate independence, poor attendance, or involvement in illegal activities
- We voted against measures to authorize management to issue shares in a Hong Kong industrial group since the measures did not include discount restrictions limiting potential dilution.

Company	Engagement Report
Ashtead Group	Ashtead is a plant hire business for commercial building projects. It operates predominantly in the US and is well positioned to benefit from any improvement in the US economic climate. They undertook a review of remuneration to ensure reward arrangements remain appropriate both in the UK where the majority of their shareholders are based, and in the US where the company has significant operations. The existing Annual Bonus Plan is being replaced by a Performance Incentive Plan which grants shares instead of cash to executives on an annual basis, with 50% of the award deferred. We believe this improves alignment between executives and shareholders but our support depends on the strength of the profit targets attached to the plan. We will make our final decision based upon the information disclosed in next year's Annual Report.
IG Group Holdings	IG Group is a spread betting business with a particular strength in financial markets. We met the chairman and, among other topics, discussed the nomination process, succession planning and the length of tenure of non-executive directors (NEDs). The board has made two new appointments during the year and it was reassuring to hear that they sought individuals with specific skills, experience and knowledge. The chairman now has regular meetings with directors below board level, to establish their suitability as executive directors should a replacement be needed quickly. IG Group believes that NEDs should remain on the board for a maximum of nine years. While this complies with the UK Code on Corporate Governance, we tend to find that NEDs' tenure is longer than nine years in order to retain their knowledge and experience. We look forward to future engagement with IG Group to discuss their views on corporate governance in more depth.

Company	Engagement Report
Dragon Oil	Dragon Oil is a company controlled by the Emirates National Oil Company (ENOC) which is developing two oil fields in the Turkmenistan portion of the Caspian Sea. We have engaged with the company over the past two years about a takeover offer and the executive remuneration policy and structure. This meeting focused on more general ESG matters and disclosure. The Caspian Sea is a non-pristine environment bordered by five countries, all of which have drilled for oil and gas for nearly 150 years. Issues discussed included disclosure on remuneration performance targets, health and safety statistics, and environmental spills, as well as political relations, broader corporate governance matters and the Framework Convention for the Protection of the Marine Environment of the Caspian Sea signed by representatives of the five littoral Caspian states. Unfortunately, the convention has not been fully implemented and Dragon Oil was not aware of its impact on the company. We have suggested the company review its broad environmental responsibilities and disclose remuneration, environmental, health and safety performance targets.
Richemont	Compagnie Financière Richemont SA is the holding Company for some of the world's leading luxury goods companies including Cartier, IWC, Montblanc and Shanghai Tang. Operating independently of each other helps maintain the integrity of the different brands. The company is listed in Switzerland. The original family retains 9.1% of the equity but has 50% of the voting rights. From a governance perspective and supply chain perspective, the structure and disclosure are not optimal. However, luxury brands do not carry the same supply chain, labour or environmental risks associated with high street manufacturers and retailers. The family is focused on long-term growth and value creation, meaning the management is aligned with the expectations of minority shareholders. Our views have not changed following a recent meeting with the company, and we continue to believe that disclosure on its approach to sustainability issues could improve.

Appendix Environmental, Social & Gov ("ESG") Overview - Q3 2011

FIL has a well established approach to responsible investment which is integral to the research process. FIL's integrated approach incorporates environmental, social, and governance ("ESG") issues into its investment process when ESG related issues may have a material impact on either investment risk or return. This role is facilitated by our Head of ESG, who acts as a focal point within FIL globally for environmental, social, and governance related activities. The Head of ESG works within the framework as outlined in our Principles of Ownership:

> FIL believes that high standards of corporate responsibility will generally make good business sense and have the potential to protect and enhance investment returns. Consequently, our investment process takes environmental, social, and governance ("ESG") issues into account when, in our view, these have a material impact on either investment risk or return. ESG best practice should be encouraged provided they enhance long term financial return.
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> We do not screen out companies from our investment universe purely on the grounds of poor ESG performance but rather adopt a positive engagement approach whereby we discuss these issues with the management of the companies in which we invest or consider investing on behalf of our clients. We use the information gathered during these meetings both to inform our investment decisions and also to encourage company management to improve procedures and policies. We strongly believe that this is the most effective way to improve the attitude of business towards corporate responsibility.

As stated above,FIL incorporates ESG into its investment process when ESG related issues may have a material impact on either investment risk or return. Examples of such risks or opportunity could include the impact of regulation (the carbon market, energy efficiency alternatives), or impacts to brand equity (reputational risks, supply chain concerns).

Below are highlights of potential issues, dialogue and company engagement noted by our investment teams in the last quarter:

The Impact of Regulation - carbon and renewables

Carbon Schemes - Australia

During the quarter, the Australian government announced further details of its carbon pricing scheme. Australia has been attempting to pass a carbon scheme since 2009, and is on its third attempt to legislate a proposal. The announced scheme outlines a fixed carbon price for three years, from $23 for each tonne of emission starting July 2012. This will rise by 2.5% per annum in real terms until 2015, when an emissions trading scheme will be introduced.

The government had pre-announced that these measures would be broadly neutral on a budgetary basis, and 55% of the revenue raised from the sale of permits in 2012-13 would be allocated to household assistance. The remainder of the programme revenue will be allocated to programs to support jobs through industry assistance, essentially through the use of carbon permits to emission intensive and trade exposed industries.

Our Australian research team has been assessing the impacts of this legislation across multiple sectors, including utilities, mining, oil & gas and transport with particular attention on companies where a pass through of cost to consumers is challenging.

Renewable Energy - Solar & Wind Use

The EU Commission has established a broad set of energy targets as part of its "20-20-20" goals. The purpose of the goals is to reduce the EU's greenhouse gas emissions by 20% compared to 1990 levels and to increase the use of renewable energy sources in overall energy consumption by 20% by 2020. To meet these targets, EU Member States have been working towards improving their energy mix and increasing their energy efficiency through various measures and regulation specific to each country.

Following the nuclear disaster in Japan there has been a significant shift in public sentiment towards renewables. This has come to fruition most clearly in Germany where the life extensions of 8 nuclear plants were not extended. The consequence of this was an increased focus on offshore wind in particular. Although other EU countries haven't yet followed suit it is a situation to monitor closely.

Despite the change in public sentiment it is important to note that the benefits are not to be shared equally amongst all renewables. In recent months we have seen changes to regulatory policy in the core markets of Germany and Italy for solar. There is a clear desire by both countries to gain control over the growth following a significant period of expansion in the last two years. We have continued to see a collapse in pricing across the solar value chain. This had made the economics of solar increasingly attractive and brings grid parity yet closer.

Nuclear - Germany

In response to the Fukushima nuclear power crisis, the German government announced plans to phase out the country's nuclear reactors. During the quarter our analysts assessed the impact of this phase out not only within the energy industry (utilities and renewables), but on companies with operations or production in Germany which may be impacted by increased energy prices.

Coal Seam Gas

Our oils and gas analyst continues to monitor regulatory and legislative initiatives in the Australian coal seam gas industry. Coal seam gas ("CSG") is often promoted as a transition fuel in a carbon constrained world as gas emissions are generally lower than coal. CSG is then converted to Liquefied Natural Gas ("LNG"). The CSG industry in Australia has seen recent development in the local market, resulting in increased publicity regarding LNG developers accessing rural agricultural property, water reservoir depletion, and contamination and encroachment on cropping lands.

Our analyst continues to monitor this issue in three ways: geography and exposure of operations to population centres, status of CSG drilling permits, and company policies / procedures in regards to land access and community concerns.

Land ownership / land access

A major issue impacting the Australian oil & gas companies that are developing LNG projects has been land owner issues. There are community concerns about the impact these projects are having on the environment (water table & impairment to cropping land). Community groups such as "lock the gate" are developing which has prompted state government to propose strategic cropping land legislation.

FIL's oil & gas analyst has been working to understand how companies are handling community relations and environmental concerns of such projects. For example, our analyst has been having costructive dialogue with **Santos Ltd.** and smaller copal seam gas players regarding these issues. Actions we have been particularly supportive of include:

- Individually visiting farmers to educate them and seek approval to enter their properties vs. sending court orders through the mail as they are allowed to do after a certain period.
- Contacting other, mostly foreign, companies at the CEO level to encourage similar behaviour with the understanding that all coal seam gas ("CSG") companies face similar challenges.
- Development of proactive community action plans and educative advertising campaigns.
- Altering drilling plans to reduce the impact on topical land use such as cropping.

Brand Equity & Reputational Risks

Negative perceptions of a Company's product supply chain can affect sales and brand equity; retailers are particularly exposed to such risks. First, companies that fail to screen suppliers adequately may unknowingly encourage dangerous and/or repressive working conditions. Second, if retailers lack appropriate controls over their supply chain (for example, due to lack of Company presence in the sourcing countries), they may be exposed to product safety risks, which could lead to product recalls, fines or lawsuits. Finally, as consumers become more sensitive to the overall sustainability and ethics of supply chains, companies that do not take account of these issues may face reputational risks.

Local communities

As discussed in previous reports, FIL's mining analyst continues to discuss public concerns arising from mining operations in Orissa, India. Scrutiny has been placed on the region following publication of reports by Amnesty International in February 2010, and July 2011 urging investors to engage with **Vedanta Resources** on environmental risks, human rights concerns and corporate governance. FIL continues to monitor the situation and is in dialogue with the companies regarding management of ESG issues.