

Annual Report 2008

Local Authority Pension Fund Forum

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1. Chairman's Statement

Well, what a baptism of fire for my first year as chair of the Forum! Who could have foreseen the dramatic events of recent months when I took on this role from my predecessor Councillor Darrell Pulk of the Nottinghamshire Fund? Darrell has certainly been a hard act to follow and we are indebted to him for the energetic and inspirational leadership that he gave.

There is no doubt that 2008 will be remembered as the point at which the house of cards of international financial risk-taking collapsed. While I am sure that many a corporate governance activist will have to bite their lip not to say "I told you so!", I believe the current crisis provides a window of opportunity to press for constructive changes that will lead to better risk control in future and, hopefully, sustainable long-term returns to investors.

Many of the issues over which the Local Authority Forum has been engaging with companies and regulators in 2008 are central to the crisis. For example, we have been persistently calling for improvements across the board in terms of audit committee practices. Audit committees have failed as one of the main checks against reckless risk-taking by executives in some of the largest banks in the world, and, sure enough, audit committees now intend to focus more on risk management as a priority.

Executive pay is back on the agenda in a big way. The experience of the banking crisis vividly demonstrates the risks shareholders run if they do not take remuneration issues seriously. The grilling of Richard Fuld, former CEO of the bankrupt Lehman Brothers, at a congressional hearing in October over the almost \$500 million in salary bonuses and stock options that he had been awarded since 2000 was one dramatic example of an urgently renewed focus on pay. Meanwhile in the UK the Financial Services Authority has written to the heads of financial institutions setting out guidance on how to calculate and structure bonuses.

Despite regulatory intervention, much remains to be done, and shareholders must push for further reform. Many corporate governance activists believe that engagement and regulation have at most slowed the ratcheting-up of executive rewards, but a way to effectively address excess still needs to be found. I believe that audit committees could make overseeing the work of the remuneration committee part of their risk management approach. More focused executive rewards are another option. The Forum itself has been at the forefront of work on how to properly incentivise directors, in particular by proposing the use of non-financial performance targets in long-term incentive schemes. I believe that this is a promising direction for the remuneration debate to take.

Away from the credit crunch the Forum has had another active and exciting year. Membership has continued to grow, and I welcome aboard Haringey, Waltham Forest, Falkirk and the Corporation of the City of London funds which joined the Forum in 2008. We have met with the boards of 12 key engagement targets, attended a string of AGMs, and engaged with 316 companies in total.

Our engagement activity has made national news, with the Forum reinforcing its position as the UK's leading investor activist organisation by spearheading investor opposition to

the nomination of Stuart Rose as the combined chair and chief executive at Marks & Spencer. And some of our long-standing engagement campaigns are beginning to reap rewards, proving that persistence helps to achieve goals. The Forum welcomed BG Group's decision to disclose a climate change target, as this had been a long-standing demand of ours. We also backed First Group's decision to appoint an independent monitor of its freedom of association policy, having led engagement with the company over labour rights in 2007.

I have no doubt that the events of the past year will have a profound impact on the future of corporate governance. The fear and uncertainty which followed the insolvency of much of the banking system has brought home to me, and I am sure to many of you, the critical relevance of the Forum's work. Our mission is, simply, to protect our beneficiaries' pensions, by promoting responsible practices in both corporate governance and CSR in the companies in which we invest on their behalf. Events in 2008 demonstrate just how important this work is. Let's get on with it!

Cllr Ian Greenwood

Chair LAPFF Forum

West Yorkshire Pension Fund

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3. LAPFF Executive 2008

Chair: Councillor Ian Greenwood – West Yorkshire Pension Fund

Deputy Chairs: Councillor Andrew Cornwell – London Borough of Islington
Councillor Winston Vaughan - London Borough of Newham

**Executive
Members**

Councillor Don Yates - Lancashire County Pension Fund
Councillor Sue Brown – Merseyside Pension Fund (until May 2008)
Councillor Cameron Rose – Lothian Pension Fund

From July 2008

Councillor Neil Fletcher – Aberdeen City Council
Councillor Ann McLachlan – Merseyside Pension Fund
Councillor Jim Middleton – Greater Manchester Pension Fund

Hon Secretary: Stuart Imeson – West Yorkshire Pension Fund

Hon Treasurer: Brian Bailey – West Midlands Pension Fund

Our mission

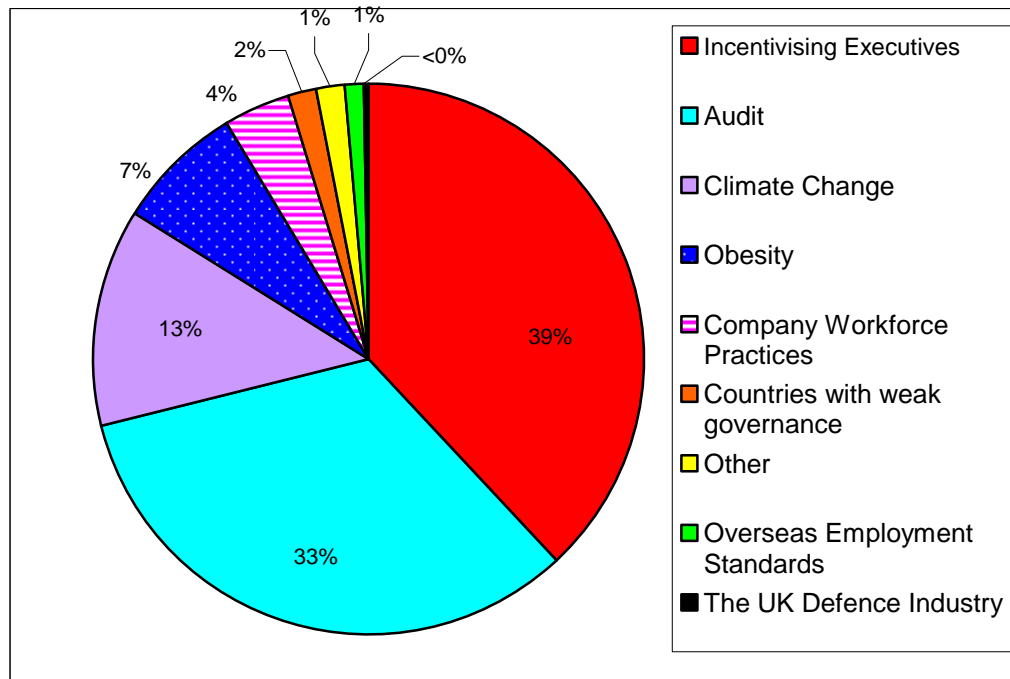
The Forum exists to serve the investment interests of local authority pension funds. In particular, it seeks to maximise their influence as shareholders in promoting the highest standards in corporate governance (CG) and in promoting corporate social responsibility (CSR) amongst the companies in which they invest. In short, it seeks to co-ordinate shareholder activism amongst local authority pension funds.

This 2008 Annual Report sets out details of the activities of the LAPFF during the year.

4. This year's highlights

LAPFF in 2008	
Number of companies engaged with	316
Number of engagement letters sent	374
Meetings with key engagement targets	12
LAPFF mentioned in the press	>100

LAPFF Engagement Focus



Case study: Marks & Spencers

Every so often there is a corporate governance concern at a company that galvanizes investor opinion. In 2008, the issue was the decision of Marks & Spencer to allow Sir Stuart Rose to combine the roles of chair and chief executive. For the Forum this has been a key engagement this year. In April we sent a letter to the company expressing opposition to the decision and seeking a meeting with the company.

The Forum chair met with the then M&S chair, deputy chair and company secretary. The Forum emphasized its concerns at the decision to breach a fundamental governance principle. However, whilst the company accepted that shareholders were unhappy with the decision it was clear that it would not revise its position.

In order to address the issue of combined roles without targeting Sir Stuart personally, LAPFF planned to table a shareholder resolution at the M&S AGM which would call on the board to appoint an independent chair. However, as the company declined to waive the significant costs of distributing the resolution and supporting statement to shareholders, this was put on hold. At the AGM a total of 22% of shareholders failed to back Sir Stuart's re-election.

For the Forum, the decision of M&S to ignore investors' concerns, and its unwillingness to facilitate the filing of the resolution, highlight a serious ongoing governance problem. Our engagement with the company will continue in 2009. To push the process forward, the Forum has endorsed a plan to file a resolution at the company's 2009 AGM if the situation has not been resolved.

Companies and others featuring in this report		
ABF	Overseas Employment Standards	6.3
Aldersgate Group	Climate Change	6.1
Arriva	Climate Change	6.1
Australian Council of Super Investors (ACSI)	Global activism	5.3
BAE Systems	UK Defence Industry	6.6
BG Group	Climate Change	6.1
BP	Incentivising Executives	5.1
Carbon Disclosure Project (CDP)	Climate Change	6.1
Carnival	Company Workforce Practices	6.2
Dana Petroleum	Climate Change	6.1
Department of Transport	Climate Change	6.1
easyJet	Climate Change	6.1
Extractive industry	Global activism	5.3
Exxon	Global Activism, Climate Change	5.3, 6.1
Financial Reporting Council (FRC)	Positioning the Forum	7
First Group	Global activism	1
Food & drinks sector	Obesity	6.4
FTSE 100	Incentivising Executives	5.1
FTSE 350	Audit	5.2
German parliament	Global activism	5.3
Greggs	Obesity	6.1
Hedge Fund Working Group (HFWG)	Positioning the Forum	7
HM Treasury	Positioning the Forum	7
Intercontinental	Company Workforce Practices	6.2
Investor Network on Climate Change (INCR)	Global Activism, Climate Change	5.3, 6.1
Marks & Spencer	Board Structure	4
Meggitt	Climate Change	6.1
National Association of Pension Funds (NAPF)	Positioning the Forum	7
National Express	Climate Change	6.1
Northern Foods	Climate Change	6.1
Office of the Rail Regulator	Climate Change	6.1
P8 Group	Climate Change	6.1
Petrofac	Countries with weak governance	6.5
Prime Minister	Climate Change	6.1
Senior Traffic Commissioner	Climate Change	6.1
Shell	Incentivising Executives, Climate Change	4.1, 6.1
Stagecoach	Climate Change	6.1
Tate&Lyle	Obesity	6.1
Tesco	Overseas Employment Standards	6.3
Total	Countries with weak governance	6.5
UN Principles for Responsible Investment	Positioning the Forum	7
United Utilities	Incentivising Executives	5.1
Vedanta	Countries with weak governance	6.1
Weir Group	Countries with weak governance	6.5
Whitbread	Company Workforce Practices	6.2

5. Corporate Governance Activism

5.1. Incentivising Executives

Our objectives

To promote the link between non-financial business performance and executive rewards amongst the FTSE 100, by

- Learning from the leaders, in particular companies with innovative incentive schemes that embrace non-financial performance measures
- Engaging with those companies in the FTSE 100 that could reasonably be expected to have such a link in place but do not.

In 2007, directors at **BP** received a much reduced payout because of a diminished Total performance measure Shareholder Return (TSR) significantly reduced remuneration rewards as a result following the string of widely publicised and catastrophic safety failures at the company. This case exemplifies one of the weaknesses of remuneration structures that rely solely on the value assigned to companies by the financial markets: while markets had finally taken notice of management of weaknesses non-financial business performance at **BP**, they did so only after the event. BP's incentive scheme had failed to do what it was designed to do – to incentivise directors to strive for financial growth and value creation that are sustainable in the long-term, a prerequisite of which required best corporate governance and corporate responsibility practices.

The Forum believes that in order to focus board directors on creating sustainable shareholder value, long-term remuneration arrangements should not only measure executive performance against financial targets but also against stretching non-financial targets in areas such as health and safety or climate change, that influence a company's long-term outlook.

In February 2008, the Forum published a baseline study of the linkage between remuneration and non-financial performance in the **FTSE 100**, which concluded that performance-based pay for executive directors is not tied closely enough to management of non-financial business issues. Only seven companies considered non-financial performance measures important enough to build them into long-term incentive plans, the main tool used to motivate executive directors to achieve high performance. **United Utilities** was the only company with a long-term incentive plan that employed more than one non-financial performance measure.

The Forum chair wrote to each **FTSE 100** company to present them with the study findings and urge them to consider the implementation of a long-term incentive plan linked to non-financial targets alongside traditional financial targets.

Over the year, the Forum met with **BP** and **Shell** to press for improvements of their safety performance, and to link it to their executive remuneration. Companies show some reluctance to deviate from traditional TSR-based schemes, because of perceived or real

opposition from shareholders as well as difficulty in evaluating non-financial performance in a meaningful way. However, the Forum's discussion with **United Utilities** provided evidence that innovative schemes do work. Operational managers, for example, may welcome such incentive schemes as they have more control over specific non-financial performance than over a company's TSR. On the other hand, because of their reliance on comparator groups, TSR schemes can lead to arbitrary results, when the underperformance of one company elevates other companies within the group, leading to increased, but largely undeserved, payouts for directors.

In February 2008 the Forum presented its findings and engaged in a collaborative discussion with like-minded investors via the **UN Principles for Responsible Investment (UN PRI)** during a webinar.

We said:

"It is encouraging that an increasing number of companies are tying directors' rewards to non-financial factors, since these can be fundamental to business success over the long term. But there is still much work to be done: if a company thinks non-financial factors are important enough to identify as key performance indicators in its Business Review then it clearly makes sense for executive incentive schemes to incentivise directors to obtain high performance in these nonfinancial performance areas." Cllr. Ian Greenwood, LAPFF Chair

5.2. Audit

Our objectives

To encourage companies to provide better quality audit committee reports and disclose policies of awarding non-audit work, by

- Conducting direct company engagement
- Continuing regulatory engagement and engaging in relevant lobbying activities
- Ensuring the Forum's views are heard, in particular by seeking representation on appropriate industry and other bodies
- Remaining up-to-date on developing issues by monitoring and responding to appropriate reports and consultations

The need for rigorous oversight by audit committees of the financial regulation and control of companies must strike a particularly resonant chord in the current climate of the 'credit crunch' and against a background of continually emerging evidence of the widespread lack of real transparency in much of the financial sector worldwide. The global economic crisis has exposed the failure of audit committees in banks to act as the first line of defence against irresponsible lending practices.

The Forum has had major concerns about the quality and independence of audit committees for many years. We launched a major engagement campaign in 2007, after our research into audit practices in the **FTSE 350** found that 23% of FTSE 350 companies did not adequately report on the activities of their audit committees. Often their disclosures amounted to little more than a summary of their audit committees' terms of reference.

We went on to write to **30 FTSE 350 companies** with inadequate audit committee reporting and **80 companies** that did not disclose policies on awarding non-audit work to their auditors. The latter issue has become increasingly high-profile in recent years. In addition to concerns about auditor independence there has also been a focus on the concentrated nature of the audit business, with the so-called "Big Four" accounting firms dominating the market for company audit services. In fact the big four accountancy firms are shifting their work increasingly towards non-audit business lines.¹

The Forum believes that companies should adhere to the recommendations in the Smith Guidance² over and above of what is included in the Combined Code, to ensure high standards of non-financial reporting, in order to avoid corporate failure. During 2009, we will review best practice and consider issuing a guide which will help companies to make the right kind of disclosures.

We said:

"Credible financial reporting is the lifeblood of efficient capital markets, which is why we as shareholders attach so much importance to audit quality and auditor independence. There are some laggards in the market who simply need pulling up to minimum acceptable standards. But the broader aim of this investor campaign is to give companies a clear message of shareholder expectations on audit, and to begin embedding best practice on issues such as terms of engagement and auditor liability." Cllr. Darrell Pulk, LAPFF chair 2005-2007

5.3. Global activism

The Local Authority Pension Fund Forum is poised to ratchet up its shareholder engagement work on the global stage. UK local authority pension funds have steadily moved their equity holdings overseas, with only 54% of assets allocated to the UK in 2007, compared to 70% in 2001.³ Our members are now exposed to varying levels of corporate practice in the different markets they invest in, compelling them to adopt a global perspective on activism, whilst at the same time facing the need to take local market variations into account.

Activism styles are quite different in other markets, a typical example being the US, where shareholder resolutions are a common tool for investors to put forward their

¹ E.g. FT, *PwC earns less than half of fees from audits*, 1 October 2008

² FRC, *The Smith Guidance on Audit Committees*, October 2005

³ WMPS, *WMPS Annual Review – UK LOCAL Authority 2006/2007*, London 2007

concerns, whereas they are seen as the 'nuclear option' in the UK. Corporate governance and CSR regimes also differ widely between markets, requiring a fair amount of local expertise. In the US, for example, investors are fighting hard for the right to nominate directors to company boards, something which UK investors are entitled to do, but hardly ever make use of. Remuneration practices in continental Europe vary from country to country, with some markets having binding shareholder votes on remuneration reports in place, and other markets not requiring any disclosure on remuneration at all. In terms of CSR, China poses risks to institutional investors because of the country's complex web of laws, politics and culture, all of which affect employment practices.

The Forum already has links to investors in other markets, for example by way of the platform provided by the **UN Principles for Responsible Investment (UN PRI)**, which we signed up to in 2007, our affiliation to the **Australian Council of Super Investors Inc. (ACSI)** and our membership in the **UN Investor Network on Climate Risk (INCR)**. We are well prepared to meet the challenge of differing market regimes and practices, and already have experience of engaging with companies and regulators in other markets. In 2008, for example, we met with the French oil & gas company **Total** to discuss their business activities in Burma; co-signed a letter to **140 global companies in the extractive industry** which urged them to follow the principles of the Extractive Industries Transparency Initiative (EITI); and successfully engaged with **regulators in Germany** on the issue of curbing shareholder activism by declaring cooperating shareholders a concert party. In addition, for the second year running, LAPFF joined forces with a group of US shareholders to push for the separation of the positions of chairman and chief executive, and the adoption of challenging, quantitative targets for greenhouse gas emissions reductions at **Exxon**.

In preparation for our global activist push in 2009, we conducted **market reviews of continental Europe, the US and the UK** during the year, and identified the themes on which to focus future engagement. In light of recent cases of 'reward for failure' at large financial institutions, there will be a focus on best practices in executive remuneration, but our choice of companies will also take into account their overall corporate governance performance in crucial areas such as audit.

We said:

"LAPFF is adopting a global vision of its role. Our experience of activism all over the world, but also market events in 2008, highlight the need to systematically address corporate governance and CSR issues outside the UK. The challenge is to be consistent in our approach in the different markets, but also to take local market variations into account. We will act globally but seek local expertise by way of collaboration with local investors and investor bodies." Ian Greenwood, LAPFF Chair

6. Promoting Corporate Responsibility

6.1. Climate Change

Our objective

To engage with FTSE 350 companies on the likely impacts of climate change on industry sectors and companies with long-term research and development programmes, and consequent risk to shareholder value.

Climate change continues to be one of the most relevant issues to address with companies. The **Carbon Disclosure Project (CDP)**, of which the Forum has been a signatory for a number of years, found in their latest survey that the level of responses globally had for the first time levelled rather than increased since the previous year.⁴ They also reported that the number of companies disclosing their emissions reductions strategies and targets has decreased.

Meaningful disclosure is one of the basic requests that the Forum is bringing to the companies it engages with. In the run-up to and after the Climate Change Bill debate in the House of Commons, the Forum co-signed a number of letters, under the aegis of the **Aldersgate Group**, to the **Prime Minister**, supporting enabling powers for mandatory carbon disclosure in the Bill.

We also pursued the issue directly with companies: the LAPFF chairman wrote to **18 UK companies** that had not responded to the **CDP's** questionnaire. As a result, three companies confirmed that they had or would imminently make a CDP submission (**Meggitt, Vedanta plc, easyJet**).

The Forum attended the Annual General Meeting of **Dana Petroleum**, Aberdeen-based E&P company, and subsequently met with the company's CEO, to move the issue of climate change reporting up the company's agenda. The Forum commended **Dana** for responding to the CDP for the first time this year, after longstanding engagement over their previous lack of climate change disclosure. The Forum also joined forces with a group of US investors to push for the adoption of challenging, quantitative targets for greenhouse gas emissions reductions at **Exxon**. A special LAPFF Alert was sent to members on this issue.

Setting emissions reduction targets is in our view a key component of corporate best practice to control climate change impact, and the Forum has sought for three years to persuade **BG** and **Shell** to set such targets (**BG**) or to substantially improve on existing targets (**Shell**). In 2008, **BG** disclosed for the first time its emissions reduction target, which the Forum publicly welcomed, recognising the difficulty in setting such a target in a rapidly expanding business. Forum representatives were also pleased to hear, in a

⁴ The Carbon Disclosure Project Report 2008, Global 500. CDP quotes deteriorating economic conditions and changes in the composition of the Global 500 as the reason.

meeting with the chairman of **Shell's** remuneration committee Sir Peter Job, of the company's intention to establish an innovative non-financial performance target, which the company also seeks to link to remuneration. This would replace the current voluntary emissions target, which expires in 2010, and which we considered inefficient.

While the standard of reporting in the oil and gas sector is generally fairly good, disclosure had to be a focus in our engagement with companies from the food and transport sectors. The Forum corresponded with **Greggs, Northern Foods, Tate & Lyle, Arriva, Stagecoach,** and **National Express,** urging them to improve their climate change reporting, in particular their disclosure of greenhouse gas emissions and in some cases emissions reduction targets. Forum representatives met with **Greggs, Northern Foods** and **National Express,** wrote to **Arriva** and attended the AGM of **Stagecoach.** **National Express** responded positively, indicating a change in the way that the company reports on non-financial performance, and making efficiency targets more stringent.

As part of the Forum's engagement with the transport sector, the LAPFF chair wrote to the **Chair of the Office of the Rail Regulator Board** in April regarding the role the ORR is taking in tackling the challenge of climate change, eliciting a positive response. The LAPFF chair also wrote to the **Senior Traffic Commissioner** to ask about current measures being taken by traffic commissioners with regard to managing risks and opportunities presented by climate change. Additionally, enquiries were made to the **Department of Transport** to ascertain the results of the 2007 consultation regarding establishing a new Board of the Traffic Commissioners and other proposed changes.

In February 2008, the LAPFF Chair along with a leading group of US and international investor bodies co-convened the **UN Investor Summit on Climate Risk** which took place at the UN headquarters in New York. This was the third summit in a series starting with the 2003 meeting which founded the **Investor Network on Climate Risk (INCR),** a network of institutional investors and financial institutions that promotes better understanding of the financial risks and investment opportunities posed by climate change. The Forum became a member of the **INCR** in 2008.

The Aldersgate Group said:

"We believe that a common protocol that is consistent with international reporting standards would be a significant driver for change and competitive advantage in the corporate sector. It would create a level playing field, allowing consumers and investors to make meaningful comparisons, and give the City the backing it needs to become the world leader in carbon accounting and reporting." Letter to Prime Minister Gordon Brown, 8 October 2008

6.2. Company Workforce Practices

Our objectives

To implement the Trustee Guide on Company Workforce Practices through engagement with companies in the Hotels and Leisure, and Food Producers sectors, by

- indentifying key performance indicators that individual companies should disclose in their business review
- exploring companies' attitudes to labour standards in areas such as pay and working conditions for agency workers in the hotels and leisure sector
- harmonisation of labour standards across all divisions of companies

Few companies are as dependent on their employees to represent their brand, and project the right image to their customers as those in the hotels and leisure sector. Accordingly, companies in this sector will admit without fail that “happy employees mean happy customers.”

Closer inspection, however, reveals that labour standards are an issue in this sector. Low pay and poor working conditions are core labour issues for agency workers in hotels. For offshore workers, in particular those from developing countries, labour standards are important, posing a challenge for cruise companies.

LAPFF has been engaging with **Carnival** since 2005 on its approach to employment practices and their disclosure. **Carnival** prides itself on its ownership of “a portfolio of the world’s most widely recognised cruise brands”, serving 7 million customers every year. There are over 60,000 crew members on board the company’s ships. The Forum met with **Carnival** in 2008 to discuss varying labour standards in its different operations, in particular when comparing European with US operations. We also explored the preparations the company had made for the incoming ILO Maritime Labour Convention.⁵ The Forum is continuing to dialogue with the company on the harmonisation of labour standards across the group and for greater transparency on its employment practices.

Closer to home, we have been discussing pay issues and working conditions for agency workers with **Whitbread** and **Intercontinental**, as part of our engagement campaign. The Forum had the opportunity to gain an in-depth understanding of the challenges that these companies face in relation to these labour issues because of their specific business models (e.g. franchise structures). The Forum continues to urge the companies for improvements in areas such as reporting and payroll auditing.

⁵ The ILO Maritime Labour Convention will enshrine in law a comprehensive set of minimum standards for the world’s 1.2 million seafarers. It covers conditions of employment, accommodation, recreational facilities, food and catering, health, medical care, welfare and social security protection. Ships governed by the convention will not be able to sail by port states without securing certificates proving that they meet the standards set out in the convention.

From the LAPFF Trustee Guide on Employment Best Practice:

“Investors need to assess how effectively companies are applying their strategic approach to risks and opportunities associated with workforce issues, in order to protect and enhance long-term shareholder value. Good reporting is a crucial requirement for the ability of investors to do so, and the disclosure of key performance indicators on non-financial performance areas such as employment is now firmly embedded in the requirements for the statutory business review.” LAPFF, Unlocking Human Capital, LAPFF Trustee Guide, 2007

6.3. Overseas Employment Standards

Our objectives

To maintain momentum in the engagement with the FTSE 100 on overseas employment standards, particularly in relation to mainland China, by

- identifying most significant CSR-related risks or opportunities faced by investee companies in China in the future
- applying the LAPFF Trustee Guide on Overseas Employment Standards in the engagement with selected FTSE 100 companies

The Forum has been dedicated for a number of years to promoting good employment standards in companies' overseas operations. A particular focus in our work is China, because foreign companies in China operate in an unusual business environment with distinctive labour conditions. A key concern is the lack of democratic or human rights. This includes the right of workers to join a trade union of their choice, and how the contravention of certain international labour standards may rebound on foreign operators in China. The Forum published its Trustee Guide “Labour Standards in China: Best Practice Guidelines” in 2007.

The Forum has been in engagement with **Tesco** over taking a leadership role in tackling labour issues in China and reporting on developments to shareholders. **Tesco** is clearly in the spotlight over labour standards, having been subject to a shareholder resolution in 2007, requisitioned by War on Want, which documented long working hours and low wages in supplier factories in Bangladesh. The Forum concluded after several years of engagement with the company that **Tesco** should be used as a benchmark on supplier audits in China to inform the Forum's dialogue with other companies. In 2008 the Forum met with **Tesco** to discuss overseas employment issues and amongst other issues, the implications of the new labour contract law in China.

The Forum also wrote to **ABF** enquiring about its efforts to address labour issues in China, in particular with regard to effective worker representation, migrant labour, low pay, working hours, supply chain management and health and safety.

We said:

“China is only going to expand in importance for many of the companies that the Forum’s members are invested in. That brings with it a whole raft of new governance and social responsibility issues for pension funds and their investment managers.” Cllr. Darrell Pulk, LAPFF chair 2005-2007

6.4. Obesity

Our objectives

To encourage companies in the food and drinks sector to address the obesity with companies in the food and drink sector.

- conducting a mailshot to all companies in the sector, providing them with an analysis of their approach to obesity and a ranking, and asking them to comment on findings and their position in the ranking
- adopting an appropriate engagement strategy with companies on the basis of company responses

Obesity poses a threat to public health and is a concern for both consumers and companies in the food and drinks industry. There is a growing consensus among government, scientists and the food sector on the need to take action to address obesity, which we believe will lead to food and drink producers and retailers facing increasing regulatory pressures concerning labelling and product information. In the Forum’s view therefore, companies in this sector should be taking proactive steps to manage their risks in the face of the rising concern about obesity. They are key players in influencing consumption decisions and must respond to changes in consumer demand for healthier options. The Forum believes that proactive companies have a window of opportunity to capitalise on the business opportunities presented by these developments.

In 2007, the Forum commissioned in-depth research into how companies are tackling the challenges. This year, the Forum used the result to engage with **22 companies in the FTSE 350 food and drinks sector**, writing to them with the analysis of their disclosure and their ranking against their peers in terms of best practice. Fifteen companies responded, of which five companies had reached the top ranking, and provided the most detailed responses to the Forum’s enquiry. On the other hand, seven of the lower ranked companies did not respond. This correlation, i.e. that more proactive companies are more ready to communicate, is not uncommon, and The Forum will therefore tailor its 2009 engagement campaign with the sector on the basis of these responses.

The Government said:

“We must do nothing less than transform the environment in which we all live. We must increase the opportunities we all have to make healthy choices around the exercise we take and the food we eat. This strategy is a first step in that transformation. It sets out how the government will discharge its responsibilities, but also calls on all members of society to act, from individuals and families to businesses and charities.” Gordon Brown, Prime Minister, 23 January 2008

6.5. Countries with weak governance

Our objectives

To pursue a focused engagement strategy with regard to FTSE 350 companies with business involvement in Sudan and consider engagement with European companies with operations in the country, by

- Writing to Weir Group and Petrofac expressing the Forum’s concerns about their operations in Sudan.
- Considering engagement with European companies with operations in Sudan.
- Maintaining a watching brief on the matter, also with a view to potentially extending engagement to other zones of weak governance.

The Forum is acutely aware of the various operational risks companies face when operating in countries that are politically unstable and provide an insecure business environment. Sudan, for example, where investors have serious concerns over human rights abuses, oil companies that operate there not only face contractual difficulties with the Sudanese government, but also difficulties with the military troops which often surround and control their operations and activities in the country. Companies therefore face reputational risks as a result of operating in Sudan which can be detrimental to the company’s image and potential value.

Are these risks outweighed by the ability of companies to “do good business” in these countries (i.e. create sustainable shareholder value and be a force for good)? The Forum has explored this question over a number of years. In 2001, we led a group of investors in drafting the “Statement from Institutional Investors – Business Involvement in Myanmar (Burma)”. This year, the Forum continued the discussion both internally and publicly. For instance, a LAPFF representative took part in a debate about the question of investing in companies operating in Burma on the **BBC Politics Show**. The Forum has also liaised with other investors via the platform provided by the **UN PRI** and is a member of the PRI’s Sudan Engagement Group.

Clearly, companies operating in countries with weak governance or human rights abuses need to be put under scrutiny. The Forum has been engaging with **Weir Group** and **Petrofac** (operations in Sudan) and **Total** (operations in Burma, land rights in Sudan). The main points put to the companies are about increasing transparency about the significance of their operations in these countries to their business strategy; and how companies' operations are beneficial for the local population for example by hiring local workers, funding environmental impact studies, addressing human rights issues.

Weir Group, a UK engineering company, has since ceased operations in Sudan. **Petrofac**, also an engineering group providing products and services to the oil and gas sector, continues to operate in Sudan. The Forum wrote in March 2008 to ask the company to explain the nature of its operations and their significance to the company's overall business strategy as well as information on its policies and procedures in operating in a sensitive country. **Petrofac** has been responsive to the Forum's contact and engagement will continue. We met with **Total** to discuss the issues. While the company has been responsive to investor concerns over the past few years, we will continue to urge **Total** to improve human rights practices in those countries.

They said:

Many multinational enterprises have demonstrated that respect for high standards of business conduct can enhance growth. (The OECD Guidelines for Multinational Enterprises)

6.6. The UK Defence Industry

Our objectives

To encourage BAE Systems to adopt a forward-thinking strategy to deal with CR risks and opportunities.

LAPFF members have been concerned about corporate responsibility issues in the defence sector for a long time, and the Forum has monitored the sector closely since 1999. An opportunity for engagement opened up after the UK government's review of the UK defence industry, and the publication of the Defence White Paper.⁶ Corporate responsibility issues go far beyond the most publicised allegations of bribery and corruption: we believe that investors need to address risks and opportunities including industrial capacity; loss of knowledge base; skills shortages and transferability to civilian sectors; and export potential.

⁶ UK MoD, *Defence Industrial Strategy: Defence White Paper*, Cm 6697, December 2005

The LAPFF Chair, together with partner investors, met with **BAE Systems** in June 2008 for what proved a constructive exchange about the company's strategic approach to non-financial issues. At this meeting the Forum urged the company to follow the recommendations made by the Woolf committee⁷, in particular the appointment of an independent auditor. In September 2008, **BAE** appointed Deloitte & Touche as its independent auditors. The Forum continues to correspond with the company, encouraging **BAE** to address the wider corporate responsibility risks it faces.

We said:

"BAE now have a robust internal strategy and mechanism that no inappropriate payments are made. The UK government has clear control over who they sell arms to. The Saudi Arabian situation was a government to government deal. BAE needs to make it clear that BAE and the government are not the same." Ian Greenwood, LAPFF Chair

⁷ The Woolf Committee was an independent committee appointed by the Board of Directors of BAE Systems, against the backdrop of criticisms made against the Company in the media, and investigations undertaken by the Serious Fraud Office (SFO) and others, relating to allegations of bribery and corruption in connection with the award of defence equipment contracts in a number of countries

7. Positioning the Forum

Our objectives

To represent the Forum's views to Government and institutional investor bodies, by

- Responding to relevant consultation papers, documents and related issues arising in the year
- Monitoring Government and professional body statements and documents, and maintain information flows through relevant networks.
- Meet with relevant parties where appropriate

During the year, the Forum has taken decisive steps to make its views heard in the relevant places, by initiating and participating in networks, using the press to influence opinion, and by providing commentary and consultation responses to regulators and other bodies.

The recent accusations levelled at hedge funds that irresponsible short selling techniques contributed to the downfall of some of the largest banks has put the spotlight again on the need for best practice guidance for the sector. The Forum responded to the **Hedge Fund Working Group's** December 2007 consultation on their proposed hedge fund standards, focusing its comments on the introduction of a best practice guideline encouraging hedge funds to adopt a proxy voting policy; disclosure of derivative positions and voting of borrowed stock.

We made a submission to the **Financial Reporting Council (FRC)** on auditors' liability limitation agreements in March 2008, setting out the Forum's belief that the recent legal allowance for auditor limited liability agreements will not increase credibility and may actually have negative implications for audit quality.

We also responded to the **HM Treasury** consultation on a review of the Myners Principles commissioned by the Government and carried out by the **National Association of Pensions Funds (NAPF)** in 2007. The response endorsed the broad strategy comprising an updated set of principles, best practice guidance, trustee tools, better quality reporting and greater industry ownership of the principles, but made specific recommendations such as giving the LGPS specific recognition with respect of the industry's ownership of the principles; and making it a principle that trustees should periodically review their responsible ownership policies and practices, and report to members on the discharge of such responsibilities. In October 2008 the Government published its decision on a new framework, including the formation of Government-industry Investment Governance Group which will be responsible for the development of, as well as best practice guidance and trustee training on the Myners Principles

The Forum also responded to the latest consultation of the **Carbon Disclosure Project**, in preparation for their 2009 reporting round. Our response proposed that the CDP questionnaire ask companies to provide information on how climate change targets are included in companies' executive incentive schemes.

In January 2008, the LAPFF chair wrote a letter to the **chairman of the finance committee of the German Bundestag** on the issue of curbing shareholder activism. The German government had tried to achieve this by way of the 'acting in concert' clause in its 'risk limitation act', which sought to restrict cooperation between shareholders by declaring them concert party. Investor criticism led the German government to dropping the clause.

During the year, the LAPFF chair wrote to the **Chair of the Office of the Rail Regulator Board** and the **Senior Traffic Commissioner** regarding climate change issues. A meeting was held by Forum representatives with the **P8 group**, comprising the world's largest pension funds to discuss possible joint action in its future climate change work.

We made use of the networking platform provided by the **UN Principles for Responsible Investment (UN PRI)**: we ran a well-attended "webinar" (or online seminar) as part of our Incentivising Executives project, and also participated in a number of **UN PRI** online events or conference calls with other **UN PRI** signatories, such as on the Carbon Disclosure Project, US Labour Standards and Sudan engagement. The LAPFF chair and honorary secretary met with **UN PRI** representatives in October 2008 to discuss engagement and networking strategies for 2009.

As further evidence of the higher international profile enjoyed by the Forum we were invited by the German Federal Ministry of Labour and Social Affairs to make a presentation about our work at a conference held in Berlin at the end of April to launch a German National Corporate and Social Responsibility (CSR) Strategy. The presentation was made by Forum Officer, Keith Bray

A LAPFF article entitled "Brave new world: UK local authority pension funds and shareholder activism" was published in Pension Funds and their Advisers, the key industry reference book. The Forum has contributed articles for magazines such Professional Pensions and Local Government Chronicle. LAPFF also continues to build its media profile, and has featured in a number of stories in the national press during the year, particularly as a result of engagement with Marks & Spencer.

8. Communicating with our members

Our mission

LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.

Our members make a fundamental contribution to fulfilling this mission. It is the direction they give the Executive Committee which drives much of the engagement programme, and members have the final say over the issues which LAPFF pursues.

Many members are actively contributing to the direction the Forum's work takes: the Honorary Secretary invites members' suggestions for future workstreams annually. The Forum's work on obesity and the defence sector are examples of projects which resulted from member suggestions. Other suggestions are frequently explored by the issuing of position papers. In 2008, Forum members were briefed on subjects such as climate change impacts associated with palm oil production, the Extractive Industries Transparency Initiative (EITI), and community issues in the mining sector.

The quarterly meetings open to all members of the Forum provide the opportunity for information exchange and discussion over a wide range of investment issues. As part of the LAPFF networking initiative, members are invited to give presentations on relevant subjects of their choice, and this year saw member presentations on several current topics. Clare Scott of the Lothian Pension Fund set out the Fund's approach to environmental, social and governance (ESG) issues and the review it had undertaken on the voting and engagement activity of the equity managers it employs; and Phil Triggs of the Warwickshire Fund gave a wide ranging presentation on hedge funds.

The Forum issues a quarterly hard-copy newsletter to its members, and during 2008 introduced a monthly bulletin distributed by e-mail. These inform members not only about current Forum activities, but also provide them with news and analysis from the wider corporate governance/responsibility community. In 2009, we will be issuing project briefings on all our work programmes. LAPFF members can find briefings on our M&A, Climate Change and Audit programs on the website www.lapfforum.org.

In December 2008, the Forum is to hold the 13th Annual LAPFF Conference, as always in Bournemouth. This year's theme, "Market risks for responsible investors", was chosen in light of the current challenging investment environment. The conference brings together a wide range of expert speakers from the City, the corporate world, academia and civil society, to help delegates make sense of the financial future. Topics covered this year include the sub-prime crisis, climate change, activist investing, human capital and fund manager assessment.

9. Outlook for 2009

The impact that part-nationalisation of some of UK's biggest banks (mirrored by similar state intervention in other nations) will have on market practices will undeniably be substantial. In the midst of the crisis the loudest calls are for a stop to 'rewards for failure', but changes to regulation and recognised market best practice may well go much deeper than that. The Forum, with its 18-year track record of promoting best practice in corporate governance and corporate responsibility, is committed to playing an important role in the debate that will ensue. Some of our existing engagement work focuses on areas of corporate governance that we believe will be the most important levers for change, and we will

- Continue to promote meaningful reporting on audit committee activities in annual reports, but also press for audit committees to adopt a business risk approach
- Continue to explore the linkage between executive remuneration and extra-financial factors, with regard to focusing executive directors on long-term prosperity instead of short-term, high risk gains
- Engage with Government and regulators on how to move on from the previously favoured light touch, 'comply or explain' approach, and towards more binding rules on company transparency and practice.

It is just as well that the road ahead will require a global perspective, as the Forum is set to becoming a truly global activist organisation in 2009. We are in the process of identifying a global focus list of companies where substandard practices in corporate governance and corporate responsibility are cause for concern in terms of companies' ability to generate sustainable returns in the long-term. Engagement with the companies on our focus list will be initiated in early 2009.

This work will be carried out alongside our existing engagement workstreams, the objectives of which we are committed to pursuing with the necessary persistence, be it to promote companies' recognition and reaction to the business risks and opportunities posed by climate change, the auditing of companies' supply chains or dealing with corporate 'dualism' of employment standards from one continent to another.

For more information about the Forum, contact
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or visit our website www.lapfforum.org

APPENDIX

LAPFF membership as at 1 November 2008

Aberdeen City Council
Avon Pension Fund
City of Edinburgh Council
City of London Corporation
Clwyd Pension Fund
Derbyshire CC
Devon CC
Dorset County Pension Fund
Dyfed Pension Fund
Falkirk Pension Fund
Greater Gwent Fund
Greater Manchester Pension Fund
Lancashire County Pension Fund
Lincolnshire CC
LB Brent
LB Camden
LB Croydon
LB Hackney
LB Haringey
LB Harrow
LB Hillingdon
LB Hounslow
LB Islington
LB Lewisham
LB Newham
LB Southwark
LB Tower Hamlets
LB Waltham Forest
London Pension Fund Authority
Merseyside Pension Fund
Norfolk Pension Fund
Northamptonshire CC
Northern Ireland Local Government Officers Superannuation Committee (NILGOSC)
North Yorkshire CC
Nottinghamshire CC
Rhondda Cynon Taf Pension Fund
Shropshire CC
Somerset CC
South Yorkshire Pensions Authority
South Yorkshire Passenger Transport Authority
Teeside Pension Fund
Tyne and Wear Pension Fund
Warwickshire Pension Fund
West Midlands Pension Fund
West Midlands PTA Pension Fund
West Yorkshire Pension Fund
Wiltshire CC
Worcestershire