



Agenda Item 9a

February 19, 2013

ITEM NAME: Global Governance Program Update

PROGRAM: Global Governance

ITEM TYPE: Program Review – Information

EXECUTIVE SUMMARY

This item provides the first quarterly update (Attachment 1) on the Global Governance Program (Program) since staff presented a new framework to the Investment Committee setting out a vision of sustainable investment focused on long-term performance. Key accomplishments include:

- **Shareowner Rights:** CalPERS engaged a new set of 50 major companies, to request majority voting, with 34 agreeing to introduce new election policies for Directors. CalPERS is carrying out a proxy solicitation at Apple to support the company's proposal to amend its Articles. Following engagement with other investors, Chesapeake Energy has agreed to sweeping governance reforms including proxy access, independent chairman, and reporting on environmental risks around hydraulic fracturing.
- **Board Quality and Diversity:** CalPERS co-hosted the Board Quality-Board Diversity event, at Toigo's Groundbreakers Summit, introducing the candidates from the Diverse Director DataSource (3D) to companies and investors.
- **Executive Compensation:** Staff has engaged an additional 200 leading companies where CalPERS voted against pay proposals. Over half agreed to improve alignment by raising performance targets or extending time periods.
- **Corporate Reporting:** CalPERS launched the Sustainable Investment Research Initiative (SIRI), a scholarly enquiry to define the factors relevant to both risk and long-term value creation, which derive from environmental, social and governance (ESG) issues. SIRI will be hosted by the UC Davis Graduate School of Management and co-chaired by faculty at Columbia Law School.
- **Regulatory Effectiveness:** Staff has met with senior Federal Congressional staff from each of the House and Senate committees responsible for financial market oversight, and the Chairmen of the Public Company Accounting Oversight Board (PCAOB) and Commodity Futures Trading Commission

(CFTC) to discuss audit reform and financial benchmarks in the wake of the London Interbank Offered Rate (LIBOR) scandal.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal of improving long-term pension and health benefits sustainability. Regular program updates support the Investment Committee in its oversight capacity.

BACKGROUND

The Program seeks good governance practices to ensure that CalPERS capital is deployed to produce sustainable long-term returns and meet pension obligations. The Program focuses on five core issues which support long-term value creation: shareowner rights; board quality and diversity; executive compensation; corporate reporting and regulatory effectiveness (see Table 1).

Table 1: Global Governance Program Core Issues

Core Issue	Objective
Shareowner Rights	<ul style="list-style-type: none"> To allow CalPERS to protect its own interests as a provider of capital.
Board Quality and Diversity	<ul style="list-style-type: none"> To strengthen the independence and competence of the boards which oversee CalPERS capital.
Executive Compensation	<ul style="list-style-type: none"> To align the incentives of companies and managers with CalPERS investment goals over the long-term.
Corporate Reporting	<ul style="list-style-type: none"> To ensure full disclosure and audit of high quality financial and ESG factors relevant to risk and value creation.
Regulatory Effectiveness	<ul style="list-style-type: none"> To support effective regulation, which protects investors, fosters stable financial markets and facilitates capital formation.

The Program is organized into five work streams (Attachment 2). Given the number of stakeholders and views, staff needs clear criteria (Table 3) for narrowing focus on issues which can be clearly linked to furthering the Program’s mission and for deciding what role CalPERS should play.

Table 3: Criteria for Evaluating Core Issues

Core Issue	Objective
Materiality	<ul style="list-style-type: none"> Does the issue have the potential for a meaningful impact on portfolio risk or return?
Principles	<ul style="list-style-type: none"> To what extent is the issue supported by CalPERS Principles of Accountable Corporate Governance?
Capacity	<ul style="list-style-type: none"> Does staff have the expertise and resources to influence a meaningful outcome?
Timeliness	<ul style="list-style-type: none"> Is the issue time sensitive with a clearly defined deadline?
Definition and Likelihood of Success	<ul style="list-style-type: none"> Is there a likelihood of success that CalPERS action will influence an outcome which can be measures; and, can we partner with others to achieve success?

ANALYSIS

The last quarter has resulted in a number of accomplishments within each of the Program’s five work streams which are described in the sections below.

1. Principles and Proxy Voting Work Stream

CalPERS Global Voting Policy states that proxy voting rights must be diligently exercised as part of the System’s fiduciary duty. Staff reviews information provided by companies, market experts, investors, and proxy advisory firms to ensure votes are cast in line with CalPERS Global Principles of Accountable Corporate Governance.

For the fourth quarter of 2012, CalPERS voted on 8,431 proposals, supporting 89% of management proposals and 68% of shareowner proposals. CalPERS voted “FOR” or “AGAINST” proposals in the U.S. and overseas on a range of issues including board independence, compensation, voting thresholds, compensation, political donations, sustainability and takeovers. During this period, all proxy votes were successfully cast.

Attachment 3 provides accomplishments for CalPERS say-on-pay proxy vote decisions over the last year and staff’s regularly reported quarterly summary of CalPERS proxy voting decisions.

2. Corporate Engagement Work Stream

Over the last quarter, CalPERS initiated engagement with seven Global Equity portfolio companies identified through the 2012 Focus List Program. In addition, CalPERS initiated engagement with 50 Global Equity portfolio companies to seek adoption of majority voting standards for director elections of which 34 are now in various stages of adoption.

Following extensive engagement by CalPERS and like-minded investors, Chesapeake Energy Corporation (CHK) announced in January 2013, significant governance changes including agreement to introduce a management proposal to adopt proxy access at its 2013 Annual Meeting, and that its Co-founder, CEO and President, Aubrey McClendon, has agreed to retire from the company on April 1, 2013.

CHK engages in the acquisition, exploration, development, and production of natural gas and oil properties in the US, and is a leader in hydraulic fracturing technology of shale rock. As of January 31, 2013, CalPERS owned about 1.43 million shares of CHK with a market value of \$29 million. Chesapeake has a market capitalization of about \$13 billion and is headquartered in Oklahoma City, Oklahoma.

In addition, key governance changes announced by Chesapeake in January 2013, are described in Table 2.

Table 2: Governance Improvements Announced by Chesapeake Energy

Governance Improvements
<ul style="list-style-type: none"> • Introduce a management proposal at the 2013 Annual Meeting to eliminate supermajority voting requirements
<ul style="list-style-type: none"> • Seek relief (in early 2013) from Oklahoma statute mandating classified boards and thus require all directors to stand for election in 2013
<ul style="list-style-type: none"> • Publish certain political expenditures on the Company's website
<ul style="list-style-type: none"> • Amend the Nominating, Governance and Social Responsibility Committee's charter to implement policies with regard to Board oversight of corporate social responsibility and director candidate diversity
<ul style="list-style-type: none"> • Adopt a compensation philosophy that emphasizes pay for performance and targets peer median compensation levels, which includes reducing executive annual incentive compensation for 2012 and awarding the CEO no bonus for 2012
<ul style="list-style-type: none"> • Approve new executive employment agreements with substantial changes from the Company's previous executive employment agreements, including the elimination of "single-trigger" change-of-control cash payments
<ul style="list-style-type: none"> • Significantly reduce perquisites for executive officers, including eliminating, or further limiting in the case of the CEO, personal use of Company aircraft

3. Capital Market Stability Work Stream

With the assistance of CalPERS Federal lobbyist, staff has arranged a series of meetings for the first quarter of 2013. The meetings are in alignment with the CalPERS 2012-14 Enterprise Business Plan initiatives to impact regulatory oversight by engaging legislative, regulatory, securities exchange, or other policy makers to address CalPERS capital market stability priorities. In-person meetings have been held with:

- **Commodity Futures Trading Commission (CFTC) Chairman:** to discuss a recent International Organization of Securities Commissions (IOSCO) report relating to financial benchmarks, including LIBOR.
- **Public Company Accounting Oversight Chairman and Board Member:** to consider the progress of global audit reform in the light of proposals from the European Commission and Parliament and consider the U.S. agenda on accounting and auditing issues.
- **Senior staff for Congressional U.S. House and Senate Leadership:** to explore opportunities to work together on financial market reform issues in the new Congress.

4. ESG Integration Work Stream

In the annual Global Governance Program Review presented to the Investment Committee in November 2012, staff outlined the next steps in CalPERS work on sustainability and integrating relevant ESG factors across the portfolio, specifically conducting a review of evidence in support of CalPERS investment beliefs. Staff has commissioned research to review the evidence of how ESG factors can impact risk and return for a large, global, and long-term asset owner such as CalPERS.

On January 25, 2013, a call for empirical and theoretical papers was released (Attachment 4) seeking submissions from scholars and investment practitioners in the fields of finance, economics, accounting, law, and business. Selected papers will be reviewed and presented at a symposium to be hosted by the UC Davis Graduate School of Management on June 7, 2013. The Ira M. Millstein Center for Global Markets and Corporate Ownership at Columbia Law School is co-chairing the selection committee for papers.

This symposium will convene leading academics and practitioners to foster a rigorous debate and discussion on sustainability, long-term value creation and capital market stability. This symposium will be an inquiry into the definitions and relevance of ESG factors and related policy issues for long-term capital providers. Senior Investment Office staff and CalPERS Board members will be invited to participate. It is expected that the results of the symposium will help inform the Investment Committee's discussion on investment beliefs.

5. Institutional Relations

Over the last quarter, CalPERS provided thought leadership through its relationship with the Robert Toigo Foundation and achieved an active leadership position with the Sustainability Accounting Standards Board. In addition, CalPERS met its annual statutory reporting requirements related to the California Public Divest from Iran and Sudan Acts.,

The Robert Toigo Foundation

CalPERS co-hosted a session entitled “Board Quality-Board Diversity” with more than 200 participants in attendance at the 2nd Annual Toigo GroundBreakers Summit held in New York on December 13, 2012. Toigo created GroundBreakers to bring senior leaders together to share insights on diversity and business trends.

CalPERS and CalSTRS partnered with Toigo to develop a panel on board diversity and quality and a networking session where investors and company representatives could meet the talent from the Diverse Director DataSource (3D) and Toigo’s All A Board candidate database. CalPERS Board member and Chair of the Investment Committee, Henry Jones, was a key note speaker and was followed by a panel of experts in the field which included: Robert Monks, Founder and Co-director, GMI Ratings; Sophie L'Helias, Senior Fellow of The Samuel and Ronnie Heyman Center on Corporate Governance, Principal, L'Helias LLC.; Doug Chia, Assistant General Counsel and Corporate Secretary, Johnson & Johnson.

Sustainability Accounting Standards Board (SASB)

CalPERS has been appointed to the standards setting advisory council of a newly established non-profit organization engaged in the development and dissemination of industry-specific sustainability accounting standards – SASB. SASB will provide investors with something they vitally need: standardized information on material ESG factors alongside financial information.

California State Legislature

CalPERS transmitted its annual reports to the California Legislature pursuant to statutory requirements of the California Public Divest from Iran and Sudan Acts.

ATTACHMENTS

- Attachment 1 – Global Governance Program Quarterly Update
- Attachment 2 – Global Governance Program Work Stream Structure
- Attachment 3 – Compilation: Principles and Proxy Voting
- Attachment 4 – Sustainable Investment Research Initiative Symposium Call for Papers

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