CalPERS

Investment Committee

Agenda Item 9a

March 13, 2017

Item Name: Global Governance Principles

Program: Sustainable Investment

Item Type: Information

Executive Summary

This agenda item is seeking feedback from the Investment Committee on its annual review of CalPERS' Global Governance Principles (Principles). Staff proposes to update the title of the Principles in line with the new strategic plan for Governance and Sustainability. Staff also proposes draft language for a new principle on capital allocation. This is one of the areas highlighted for future development during the detailed review of the Principles last year. Pending Investment Committee feedback, the proposed revisions to the Principles outlined in this item will be incorporated into the second reading of the revised Total Fund Policy, currently scheduled for the April 2017 Investment Committee meeting.

At the Investment Committee's direction, Staff has also prepared engagement options for consideration related to the Dakota Access Pipeline (DAPL) as it relates to CalPERS' Principles. These include engaging corporate entities, banks, stakeholders, and proxy voting related to DAPL (Pages 5 – 7).

Strategic Plan

This agenda item supports CalPERS' Strategic Plan goal to strengthen the long-term sustainability of the pension fund.

Investment Beliefs

This agenda item is applicable to the following CalPERS' Investment Beliefs:

- Investment Belief 2: A long time investment horizon is a responsibility and an advantage.
- Investment Belief 3: CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.
- Investment Belief 4: Long-term value creation requires effective management of three forms of capital: financial, physical, and human.

Background

In March 2015, the Investment Committee established an ad hoc subcommittee consisting of Henry Jones, JJ Jelincic, Ron Lind, Bill Slaton, and Betty Yee, for the purpose of reviewing the Principles. In March 2016, the Investment Committee voted to approve the revised Principles, which were redrafted as follows:

1. Restructured into five "core" chapters, removed duplications, and integrated appendices as principles. The remaining two appendices are:
   - Appendix A – United Nations Supported Principles for Responsible Investment (PRI)

- Appendix B – List of Memberships and Endorsements by CalPERS

2. Revisions to the Introduction and Purpose sections:
   - These include new references to the Regulatory Environment, Financial Markets, and Environment, Social, and Governance issues
3. New Principles:
   - Board Quality: Diversity, Independence, and Competence
     i. Director Tenure
     ii. Board Attributes: to include climate competence boards
     iii. Human Capital Management Practices
     iv. Diversity: to include gender identity and sexual orientation
   - Regulatory Effectiveness: properly funding regulators
   - Compensation: removed 'executive'

The Principles are currently included as an Attachment A within the Global Governance Program Policy. At the February 2017, Investment Committee meeting staff proposed several revisions to the Total Fund Policy including the incorporation of the Global Governance Program Policy and Principles. The February 2017, agenda item did not propose any changes to the Principles, with the exception of two typographical errors. Pending feedback from the Investment Committee, the proposed revisions to the Principles in this item will be incorporated into the second reading of the revised Total Fund Policy, which is scheduled for the April 2017, Investment Committee meeting.

Analysis
During the in-depth Principles review, staff compiled a list of areas to consider for future review and development provided below in Table 1. Over the next five years, Staff plans to return to the Investment Committee with further exploration of these areas as part of the annual review process for the Principles. For this year's Principles review, staff focused on the items highlighted with red circles in Table 1. Staff's review concluded with a recommendation to add a new capital allocation principle, which is presented today for the Investment Committee's consideration.

Table 1: CalPERS' Principles – Areas to Consider for Future Review and Development

Subject	Issue
Investor Rights	Related Party Transactions Judicial Forum – Loser Pays (fee shifting) Further consider joint ventures Proxy Access – "minimum" standards (beyond SEC) for nominee disclosure Board Turnover/Refreshment – Explore options and concepts for independent director refreshment Interlocking Directorships
Compensation	Employee Compensation (Sullivan Principle) – Income inequality for future development following CalPERS' symposium. Consideration of retirement security and fair wages. Share buybacks and executive compensation Review of performance metrics linked to equity awards Review stock option weaknesses and short-term focus
Capital Allocation	Share buybacks and dividends Address what is meant by "excessive debt leverage"

Table 1: CalPERS' Principles – Areas to Consider for Future Review and Development	
Subject	**Issue**
Environment and Climate Change	Water-related issues Clean air Review best practices following Paris Climate Agreement - COP 21
Total Fund Emphasis	Principles in the current form have a bias to equity Explore how to better incorporate reference to other asset classes
Human Capital Management	Review and develop supply chain principle
Vote Disclosure Language	Develop post-AGM proxy vote disclosure language

Source: March 14 2016, Investment Committee Agenda Item 5a.

Staff used the Governance and Sustainability Subcommittee (GSS) Research Working Group, a subcommittee of the Investment Strategy Group (ISG), to start the review on capital allocation specifically related to share buybacks, compensation, and debt leverage. Staff has reviewed research and best practices among global peers and managers to draft language on capital allocation which address several of these issues highlighted during the 2016 Principles review.

The approach taken on the new capital allocation principle focuses on board responsibilities in addressing capital allocation to ensure discipline to support long-term value creation and avoid undue impact on executive compensation performance targets. The principle development surrounding capital discipline is timely. Currently through our engagement program we are focusing on capital allocation and discipline in Japan, CalPERS' second largest market. In addition, the United States (CalPERS' largest market) is expecting a flow of repatriated funds. Thus, providing clarity on CalPERS' Principles surrounding capital allocation and discipline is highly relevant.

Proposed Language

Staff proposes the following language to be included in the Principles:

Section	Principle	Proposed Revisions
Title & Footer		Staff proposes to update the title of the Principles in line with the new strategic plan for governance and sustainable investment from "CalPERS' Global Governance Principles" to "CalPERS' Governance & Sustainability Principles."
Board Quality: Diversity, Independence and Competence	Board Responsibilities – Corporate Strategy (Attachment 3 - Page 14)	Staff proposes to extend the language on "Board Responsibilities - Corporate Strategy" of the Principles to provide clarity on capital allocation. <u>Current Principle Language:</u> **7. Board Responsibilities:** The board responsibilities should include: a. **CEO Performance:** Independent directors establish CEO performance criteria focused on optimizing operating performance, profitability and shareowner value creation; and regularly review the CEO's performance against those criteria. **b. Corporate Strategy:** Review, approve and guide corporate strategy, capital discipline and allocation, major plans of action, risk policies, business plans.

Section	Principle	Proposed Revisions
		Proposed Principle Language: **7. Board Responsibilities:** The board responsibilities should include: a. **CEO Performance:** Independent directors establish CEO performance criteria focused on optimizing operating performance, profitability and shareowner value creation; and regularly review the CEO's performance against those criteria. b. **Corporate Strategy**: Review, approve, and guide corporate strategy, capital allocation discipline, major plans of action, risk policies, and business plans. i. **Capital Allocation Discipline**: Boards should provide shareowners with robust oversight and disclosure surrounding capital allocation decisions, including optimizing the capital structure to ensure discipline in prioritizing the most productive use of capital over the long-term. We recommend the following: a) **Policy**: The board should develop and disclose its policy on capital allocation that outlines the application of discretionary cash flows for organic growth projects, investments, strategic mergers and acquisitions, cash and scrip dividends, debt repayment, and share repurchases. The board should also communicate its philosophy on the use of debt leverage. b) **Board Monitoring and Assessment:** The board should monitor capital allocation decisions and the range of capital allocation alternatives and their corresponding risks. c) **Disclosure:** The board should disclose in regulatory filings: i. The board's role in overseeing capital allocation decisions and how each decision aligns with the company's strategic priorities for investment to ensure long-term value creation; ii. The controls and metrics in place to monitor capital allocation decisions; iii. The impact on performance targets in executive compensation plans; and iv. The board's measures to address potential conflicts of interest with incentives impacted by capital allocation decisions, such as share buybacks.

Dakota Access Pipeline (DAPL) Engagement
At the February 13, 2017, Investment Committee meeting, staff was directed to explore engagement options related to the controversy around DAPL as it relates to CalPERS' Principles.

DAPL is a $3.78 billion 1,172-mile pipeline project which will carry crude oil from the Bakken/Three Forks area in North Dakota to Patoka, Illinois. For the final section of the pipeline more than one route was considered, including a route 10 miles north of Bismarck and another route approximately half of a mile upstream of the Standing Rock Sioux tribe's reservation. Following concerns around the potential impact on drinking water quality around the town of Bismarck the route near the Standing Rock Sioux tribe's reservation was selected.[1] This is being protested by the Standing Rock Sioux and Cheyenne River tribes, due to the selected route's proximity to the tribes' water supplies and sacred sites. Following delays, the final construction is underway.

DAPL Ownership
The construction of DAPL is being undertaken by Energy Transfer Partners, L.P. (ETP) and Sunoco Logistics Partners, L.P. (SXL), two publically-traded master limited partnerships that recently announced a merger[2]. Once the merger is completed the company will be referred to as ETP.

In addition to ETP, the other corporate entities with ownership in DAPL[3] are the following:

- MarEn Bakken Company LLC (MarEn): a joint venture between MPLX, L.P. and Enbridge Energy Partners, L.P.
    - MPLX, L.P. (MPLX) is a publically traded master limited partnership formed in 2012 by Marathon Petroleum Corporation (MPC), a publically traded company.[4]
    - Enbridge Energy Partners, L.P. (EEP) is a publically traded master limited partnership and a subsidiary of Enbridge, Inc. (ENB), a publically traded company.[5]
- Phillips 66 (PSX): a publically traded company

CalPERS has the following public debt and equity exposure in the companies involved in DAPL.

CalPERS' Equity and Debt Holdings Related to DAPL (as of December 31, 2016)			
Name	**CalPERS' Equity**	**CalPERS' Debt**	**CalPERS' Total**
Energy Transfer Partners, L.P.	$35,955,173	$68,135,850	$104,091,023
Sunoco Logistics Partners, L.P.	$14,087,730	$17,491,260	$31,578,990
MPLX, L.P.	$18,191,494	$33,035,055	$51,226,549
Enbridge Energy Partners, L.P.	$13,160,420	-	$13,160,420
Phillips 66	$155,515,101	-	$155,515,101

[1] US Army Corps of Engineers FAQ, URL: http://www.usace.army.mil/Dakota-Access-Pipeline/FAQs/
[2] Energy Transfer Partners, L.P. and Sunoco Logistics Partners, L.P. merger announcement on November 21, 2016. URL: http://www.sunocologistics.com/SiteData/docs/pressrelea/0bfa0fa83ffa8df1/press%20release%2011.21.2016.pdf
[3] ETP Press Release (February 16, 2017) URL: http://ir.energytransfer.com/phoenix.zhtml?c=106094&p=irol-newsArticle&ID=2246475.
[4] MPLX, L.P. About Us URL: http://www.mplx.com/About_MPLX/
[5] Enbridge Energy Partners, L.P. URL: https://www.enbridgepartners.com

Engagement Options
Staff highlights the following engagement options:

1. **Company Dialogue**
   CalPERS has initiated dialogue with the management of ETP. Staff reviewed ETP's governance against CalPERS' Principles and highlight the following:
   - Equity investors have no voting rights
   - CEO/Chairman roles are combined, with no Lead Independent Director
   - Majority of the board are not independent directors, including audit committee
   - Lack of diversity on board
   - No director equity policy or clawback policy on compensation

   As ETP is a master limited partnership controlled by a general partner, Energy Transfer Partners, GP. ETP is not required to have a standard annual general meeting with the ability for shareowners to vote on the board of directors, auditors or put shareowner proposals forward. Due to a provision under the Dodd-Frank Act, in 2014 ETP held a special meeting requesting approval to amend their 2008 long-term incentive plan via increase of shares authorized for the issuance under the plan. CalPERS supported this proposal and it passed with 94% support.

2. **Stakeholder Dialogue**
   CalPERS has hosted an investor briefing with leaders of the Standing Rock Sioux tribe in order to better understand their concerns around DAPL. The Standing Rock Sioux tribe supports pipeline construction to foster economic development, energy security and independence. Their concerns on the pipeline construction are specific to the final section's proximity to their water supplies and sacred sites.

3. **Engagement with Banks**
   CalPERS is engaging the banks financing DAPL and highlighting their commitment to international best practices such as the Equator Principles[6]. These are a financial industry credit risk framework for determining, assessing, and managing environmental and social risk in projects. The Equator Principles advise "projects with adverse impacts on Indigenous Peoples will require their Free, Prior, and Informed Consent" (Principle 5: Stakeholder Engagement). The Equator Principles require that environmental impact assessments and stakeholder consultation are embedded into covenants for loans. Thirteen of the 17 banks are signatories to the Equator Principles.

   CalPERS has also supported a statement (see attachment 5) asking the 17 major U.S. and international banks financing DAPL to address or support tribal requests for a peaceful solution. The statement has been supported by 130 global investors, representing approximately $1.2 trillion AUM.

4. **Proxy Votes**
   We anticipate shareowner proposals at various companies related to DAPL focusing on requests for a report that describes the due diligence process used to identify and address environmental and social risks, including Indigenous rights risk. The SEC is allowing such shareowner proposals to go to the vote, having declined a request for a 'no-action' letter at Marathon Petroleum Corporation.

   CalPERS will review shareowner proposals related to DAPL on a case-by-case basis, consistent with CalPERS' Principles. The relevant section of CalPERS' Principles is:

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[6] Equator Principles, URL: http://www.equator-principles.com/

"[Section D. Corporate Reporting - #5. Stakeholder Relations]: CalPERS believes that corporations should strive for active cooperation with stakeholders (and thereby...) will be most likely to create wealth, employment and sustainable economies. With adequate, accurate and timely data disclosure of environmental, social, and governance practices, shareowners are able to more effectively make investment decisions by taking into account those practices of the companies in which the System invests."

Budget and Fiscal Impacts
Not Applicable

Benefits and Risks
Review of CalPERS' Principles is consistent with the Investment Office's Target Operating Model objectives to design, develop, and implement a robust operating model that minimizes complexity, improves transparency, and strengthens processes, systems, governance, and controls. Misalignment between Investment Office strategic planning and the Investment Committee's adopted Principles can increase the risk of lack of clarity in implementation.

Responding to stakeholder inquiries is an important part of CalPERS' Investment Beliefs. The risk of not responding to stakeholder inquiries may pose reputational risk and, in some cases, pose financial risk to the fund.

Attachments
Attachment 1 – CalPERS' Global Governance Principles Presentation
Attachment 2 – CalPERS' Governance & Sustainability Principles (Track Changes)
Attachment 3 – CalPERS' Governance & Sustainability Principles ("Clean" View)
Attachment 4 – Wilshire Associates' Opinion Letter
Attachment 5 – Investor Statement to Banks Financing DAPL

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