

March 19, 2018

Item Name: Governance and Sustainability Principles**Program:** Sustainable Investments**Item Type:** Information**Executive Summary**

This agenda item provides the annual review of CalPERS' Governance and Sustainability Principles ("Principles"). It proposes new language in response to emerging issues, topics identified from the 'Areas to Consider for Future Review and Development' list and editorial revisions to improve accessibility. Staff is seeking feedback and guidance on the proposed revisions. Pending Investment Committee feedback, the proposed revisions to the Principles outlined in this item will be incorporated into Appendix 8 of the Total Fund Policy. Staff plans to return to the Investment Committee in April 2018 for a first reading of the revised Total Fund Policy.

Strategic Plan

This agenda item supports the CalPERS 2017-22 Strategic Plan goal of Fund Sustainability, and the 2017-18 Business Plan goals of Investment Beliefs and Environmental, Social and Governance Risk Integration. Revision of the Principles is included in the 5-year ESG Strategic Plan for Sustainable Investment.

Investment Beliefs

This item supports the following CalPERS' Investment Beliefs:

- Investment Belief 2, regarding the responsibility and advantage of a long-term investment horizon and the sub-beliefs which require that CalPERS encourage companies and external managers to consider the long-term impact of their actions.
- 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.
- Investment Belief 9: Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.

Background

The Principles set out "our views on best practices guiding our engagement with companies, advocacy agenda with policy makers, and expectations for both our internal and external managers across the total fund."

In March 2015, the Investment Committee established an ad hoc subcommittee to review the Principles. In March 2016, the Investment Committee voted to approve the revised Principles, which distilled over 100 pages into a new structure focusing on core issues: 1) Investor Rights,

2) Board Quality: Diversity, Independence and Competence, 3) Compensation, 4) Corporate Reporting, 5) Regulatory Effectiveness.

The review highlighted a range of areas to be considered for review and development over the course of the ESG Strategic Plan for Sustainable Investment.

Table 1 provides the list staff compiled for areas to consider for future review and development, checks the revisions approved in March 2017 and circles the subjects to be discussed at the March 2018 Investment Committee meeting.

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” ✓
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

✓ Approved in 2017

Analysis

The Governance and Sustainability Subcommittee (“Subcommittee”) to the Investment Strategy Group, formed a Research Working Group (“RWG”) in 2017 to respond to the research-related projects detailed in the ESG Strategic Plan for Sustainable Investment. The Subcommittee approved the list of Principles’ review topics for its RWG to work on in 2017-18.



The RWG consists of representatives from each asset class, Trust Level Portfolio Management and Sustainable Investment Program. RWG members researched, drafted and discussed the language presented as 2018 proposed updates to the Principles with fellow members. The Subcommittee then approved each recommendation.

Emerging issues: Over the course of 2016-17, staff’s engagement with stakeholders and portfolio companies highlighted potential issues for inclusion to the Principles. Addressing these areas enables staff to have greater clarity on CalPERS’ position and ensure new issues are addressed within our fiduciary duty when involved in advocacy, integration, responding to stakeholders, engaging companies, voting proxies and reviewing emerging disclosure standards.

Table 2: Staff identified the following emerging issues for the 2018 Principles review in order to seek feedback from the Investment Committee:

Table 2: CalPERS’ Principles – Emerging Issues	
Issue	Rationale
Clawback Policy	In response to the Equifax controversy and to ensure our Principles’ clawback principle would address related concerns.
Board Responsibility for Product Safety	In response to recent stakeholder requests on topics related to product safety such as the opioid crisis, antibiotics in animal feed and impact of chemicals on human health.
Geopolitical Risk	To address potential geopolitical risks (for example issues raised by Brexit, the Korean Peninsula, South Africa, Turkey, and the Middle East).
Enhanced Disclosure on Human Capital Management	To ensure the Principles are aligned with the Human Capital Management Coalition’s petition to the SEC for rulemaking disclosure to which CalPERS is a founding signatory.
Indigenous Peoples’ Rights	Following public comment regarding controversies surrounding the Dakota Access Pipeline (DAPL) at the February 2017 Investment Committee meeting, CalPERS’ Board directed staff to engage relevant portfolio companies. From these engagements, staff is recommending new language to clarify our commitment to the UN standard of free, prior and informed consent.

Updates to enhance accessibility: Staff has recommended revisions in line with CalPERS’ broader efforts to increase accessibility of CalPERS’ communications to a wide variety of audiences.

The draft language in response to the topics noted in Tables 1 and 2 is itemized in Attachment 1. Attachments 2 and 3 contain draft versions for comment of the 2018 Governance and Sustainability Principles incorporating all the above changes as tracked changes and “clean” versions, respectively. Attachment 4 is Wilshire Consulting’s opinion letter on the Principles.

Budget and Fiscal Impacts
Within existing budget

Benefits and Risks



Annual review by the Board 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. The progress and completion of the Plan strategic priorities are an integral part of achieving long-term fund sustainability. As objectives are achieved, the following benefits are expected:

- Strengthened understanding of ESG factors relevant to risk and return specific to CalPERS' investment objectives
- Reduced exposure to ESG risk through enhanced disclosures of ESG considerations in periodic filings globally
- Enhanced Total Fund performance by increased corporate board diversity

Attachments

Attachment 1 – CalPERS' Governance & Sustainability Principles Presentation

Attachment 2 – CalPERS' 2017 Governance & Sustainability Principles (Tracked Changes View)

Attachment 3 – CalPERS' Governance & Sustainability Principles ("Clean" View)

Attachment 4 – Wilshire Associates' Opinion Letter

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