CalPERS' Governance and Sustainability Principles

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CalPERS | Investment Office

Overview | Governance & Sustainability Principles Update

Seek Investment Committee's feedback on revisions to the Governance & Sustainability Principles, including:

- Proposed language on items from the 'Areas to Consider for Future Review and Development' list, namely: compensation, environment and climate change
- Proposed language on emerging issues, namely: product safety, executive compensation clawback policies, geopolitical risk, enhanced disclosure on human capital management, and Indigenous Peoples' rights
- Updates to enhance accessibility

Next Steps

- Continue to research areas for future development and consider emerging issues

Investment Office's Process for Revisions

Board's Investment Committee

- The Governance and Sustainability Principles are part of the Total Fund Policy.
- The Investment Committee provides feedback to revisions to the Principles annually in March and the first reading of the Total Fund Policy takes place in April.

Investment Office's Internal Process

- The Investment Strategy Group has a Governance and Sustainability Subcommittee. The Subcommittee formed a Research Working Group (RWG) with representatives from each asset class, Trust Level Portfolio Management and Sustainable Investment Program to respond to the research-related projects detailed in the ESG Strategic Plan for Sustainable Investment.
- 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.

Areas to Consider for Future Review and Development

The Board requested INVO to address the topics below in the Governance and Sustainability Principles over the course of the 5-year ESG plan. This year's updates are circled in red.

✓ Approved in 2017

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
Capital Allocation	• Share buybacks and dividends ✓ • Address what is meant by "excessive debt leverage" ✓
Compensation	• Share buybacks and executive compensation ✓ • Employee Compensation (Sullivan Principle) – Income inequality for future development following CalPERS' symposium. Consideration of retirement security and fair wages. • Review of performance metrics linked to equity awards • Review stock option weaknesses and short-term focus
Environment and Climate Change	• Water-related issues • Clean air • Review best practices following Paris Climate Agreement - COP 21
Total Fund Emphasis	• Explore how to better incorporate reference to other asset classes ✓ • Principles in the current form have a bias to equity
Human Capital Management	• Review and develop supply chain principle
Vote Disclosure Language	• Develop post-AGM proxy vote disclosure language

Emerging Issues – Proposed Principles Revisions

Over the course of 2016-17, staff's engagement with stakeholders and portfolio companies highlighted potential areas for improvement to the Principles. The Investment Office's Research Working Group to the Governance and Sustainability Subcommittee proposes the following list of topics.

Topic	Rationale
Clawback Policy	In response to the Equifax controversy and to ensure our existing 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 for rulemaking to which CalPERS is a founding signatory.
Indigenous Peoples' Rights	Following public comment regarding controversies surrounding the Dakota Access Pipeline at the February 2017 Investment Committee meeting, CalPERS' Board directed staff to engage relevant portfolio companies. From these engagements, staff is recommending principles to clarify our commitment to the UN standard of free, prior and informed consent.

Areas to Consider for Future Review| Compensation

In light of the SEC issuing a rule to implement the Dodd-Frank requirement, staff recommends updating the Compensation section with the following language:

Section	Principle	Proposed Language	Page
C. Executive, Director, and Employee Compensation	1. Total Compensation – Structure and Components	**j. CEO Pay Ratio Disclosure:** Companies should disclose the ratio of CEO compensation to the median annual total compensation of all other employees, and the methodology used to determine the ratio.	Attachment 3 - Page 24

Areas to Consider for Future Review| Environment & Climate Change

Staff recommends updating the Corporate Reporting section with the following: language:

Section	Principle	Proposed Language	Page
D. Corporate Reporting	6. Environmental Management Practices	CalPERS' believes companies' long-term value creation requires effective management of environmental risks and opportunities. Companies should identify and manage material environmental risks and opportunities that are relevant to their short and long-term success. Environmental issues may include the following: **I. Environmental effects on company**: change, volatility or deterioration in the environment that may impact business operations, such as: • climate change, extreme weather • loss or degradation of ecosystem services (e.g. pollination), decline of biodiversity • change in access to clean, affordable and adequate sources of water and other critical natural resources (e.g. natural food supplies) **II. Company impact on the environment**: Potential regulatory change, liability, license to operate, reputational or market access risks posed by the company's environmental impacts, including: • emissions, pollution, waste, degradation of natural ecosystems (e.g. deforestation) **III. Transition**: Transition of company's industry and/or customers toward more sustainable products, services or practices, such as: • low carbon economy, technologies improving environmental outcomes • sustainability certifications, restoration, adaptation and risk mitigation business models	Attachment 3 - Page 32

Areas to Consider for Future Review| Environment & Climate Change

Staff recommends updating the Corporate Reporting section with the following:

Section	Principle	Proposed Language	Page
D. Corporate Reporting	6. Environmental Management Practices	With regard to material environmental risks and opportunities, good practices include: **a. Board Oversight:** i. The board identifies and oversees management of material environmental risks and opportunities and sets robust and relevant environmental strategy, time-bound goals and/or targets[1]. ii. Board member(s), board committee(s) or full board have pertinent environmental knowledge and experience, or have a designated committee or other such body with the ability to access independent sources of such knowledge and experience. iii. Alignment of lobbying activities and company expenditures with environmental strategy. **b. Management Execution:** i. Senior executives manage the development and execution of science-based and time-bound environmental strategies, goals and/or targets. ii. Risk and opportunity management throughout the value chain, strategic planning and general business activities integrate environmental considerations. iii. Executive officers' compensation is linked to attainment of environmental goals and targets. iv. The company calculates environmental metrics relevant to its business operations annually, including, but not limited to, greenhouse gas emissions. [1] The global climate change agreement reached at the 21st Conference of the Parties (COP21), "The Paris Agreement", provides globally agreed, and CalPERS endorsed, targets related to climate change.	Attachment 3 - Page 32

Areas to Consider for Future Review| Environment & Climate Change

Staff recommends updating the Corporate Reporting section with the following:

Section	Principle	Proposed Language	Page
D. Corporate Reporting	6. Environmental Management Practices	**c. Disclosure on Environmental Risks and Opportunities [2]:** With regard to material environmental risks and opportunities, company disclosures should cover the following: i. Governance: Company's governance around environmental risks and opportunities. ii. Strategy**:** Actual and potential impacts on the company's businesses, strategy and financial planning. i. Risks and opportunities the company has identified over the short, medium and long-term. ii. Environmental commitments the company has made including timelines, targets and impact on financial statements and business strategy. iii. Engagement with policy makers regarding environmental risks and opportunities material to company (including related expenditures). iii. Risk Management**:** How the company identifies, assesses, and manages environmental risks and opportunities including the following: i. How the company works to ensure its business models and supply chain are robust, responsive and/or resilient. ii. If and how the company uses internal pricing for carbon, water or other natural resources. iii. How the company manages traceability issues in its supply chain. iv. How the company identifies and manages impacts, or potential impacts, on local environments and communities including company's approach to material human capital issues. (e.g. public health, land rights and just transition in relation to workers). iv. Metrics and Targets**:** Environmental metrics[2] used to assess and manage relevant environmental risks and opportunities, noting where third party verification has been used . These metrics should be decision-useful, for both the company and investors. Performance relative to targets and commitments should also be disclosed. [2]The Task Force on Climate-Related Financial Disclosures (TCFD), the Sustainability Accounting Standards Board (SASB), GRESB and CDP offer useful investor endorsed disclosure guidance pertaining to climate impacts, deforestation, water and other potentially material environmental factors.	Attachment 3 - Page 32

Emerging Issue| Clawback Policy

Staff recommends updating the Compensation section with the following language:

Section	Principle	Proposed Language	Page
C. Executive, Director, and Employee Compensation	3. Incentive Compensation	**g. Clawback Policy:** Companies should develop and disclose polices to recapture compensation made to executives during periods of fraudulent activity, inadequate oversight, misconduct, or gross negligence, which impacted or is reasonably expected to impact financial results or cause reputational harm. Companies should provide shareowners disclosure when compensation has been cancelled or recouped consistent with policy.	Attachment 3 - Page 25

Emerging Issue| Product Safety and Geopolitical Risk

Staff proposes adding product safety and geopolitical risks to the Risk Oversight section:

Section	Principle	Proposed Language	Page
B. Board Quality: Diversity, Independence, and Competence	Board Responsibilities – Corporate Strategy	Staff proposes to extend the language on "Board Responsibilities - Corporate Strategy" of the Principles to provide clarity on capital allocation. **13. Risk Oversight:** In response to the turmoil in the financial markets and economic uncertainties, CalPERS has elevated the importance of risk oversight and management. The primary goal is to ensure companies adopt policies, operating procedures, internal controls, federal and state law compliance programs, reporting, and decision-making protocols to effectively manage, evaluate, and mitigate risk. The ultimate outcome is to ensure that companies function as "risk intelligent" organizations. CalPERS recommends the following: a. … b. … c. The board should set out specific risk tolerances and implement a dynamic process that continuously evaluates and prioritizes risks. An effective risk oversight process considers both internal and external company related risks such as operational, financial, credit, solvency, liquidity, corporate governance, cyber-security, environmental, reputational, social, **product safety**, and external risks such as **geopolitical,** industry related, systemic, and macro-economic.	Attachment 3 - Page 20

Emerging Issue| Human Capital Management

Staff proposes enhancing the existing Corporate Reporting section to include the following:

Section	Principle	Proposed Language	Page
D. Corporate Reporting	1. Integrated Financial Reporting	**1. Integrated Financial Reporting:** Financial reporting plays an integral role in the capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards, as well as consistent application, rigorous independent audit and enforcement of those standards. Companies should provide for the integrated representation of operational, financial, **human capital management practices**, environmental, social, and governance performance in terms of both financial and non-financial results in order to offer investors better information for assessing risk. The board should provide an integrated report that puts historical performance into context, and portrays the risks, opportunities and prospects for the company in the future, helping shareowners understand a company's strategic objectives and its progress towards meeting them.	Attachment 3 - Page 30

Emerging Issue| Indigenous Peoples' Rights

Staff proposes enhancing the existing Board Quality section to include the following factors:

Section	Principle	Proposed Language	Page
B. Board Quality: Diversity, Independence, and Competence	16. Human Capital Management Practices	**1. Universal Human Rights:** Express support for universal human rights and particularly, for employees and communities within which the company operates and parties with whom the company does business with. **This includes free, prior, and informed consent as a standard in relation to Indigenous Peoples' rights.**	Attachment 3 - Page 22