

**April 16, 2018****Item Name:** Proposed Revisions to Governance and Sustainability Principles**Program:** Sustainable Investments**Item Type:** Information**Executive Summary**

This agenda item provides the second reading of CalPERS' Governance and Sustainability Principles (Principles). It proposes new principles on sexual harassment in response to the Board's direction at the March 19, 2018, Investment Committee meeting. In addition, this item provides a response to the Treasurer's letter on board diversity dated November 28, 2017.

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 May 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 (ESG) 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.
- Investment Belief 10: Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives. Sub-belief: "Diversity of talent (including a broad range of education, experience, perspectives and skills) at all levels (Board, staff, external managers, corporate boards) is important."

**Background**

At the March 19, 2018, Investment Committee meeting staff presented its annual review of the Governance and Sustainability Principles. During the review the Board directed staff to propose new language on sexual harassment to be included in CalPERS' Principles. The Board also

directed staff to provide a response to the Treasurer's letter on board diversity dated November 28, 2017.

## **Analysis**

### Principles on Corporate Culture, including Sexual Harassment

The Governance and Sustainability Subcommittee ("Subcommittee") to the Investment Strategy Group, formed a Research Working Group ("RWG") in 2017 to undertake projects detailed in the ESG Strategic Plan for Sustainable Investment and assist with the response to stakeholder requests.

The RWG consists of representatives from each asset class, Trust Level Portfolio Management and Sustainable Investment Programs. Following the Board's direction, RWG members researched, drafted and discussed the language recommended as an update to the Principles with fellow Subcommittee members, such as the Legal Office.

Staff reviewed potential resources for investors including the Council for Institutional Investors (CII) [report](#) on "How Corporate Boards Can Combat Sexual Harassment" published March 2018 (Attachment 1). This report offers recommendations and resources for boards of directors to mitigate the risk of sexual harassment. In addition, the report provides a list of questions shareowners can ask directors to understand the quality of their oversight of corporate culture, specifically around preventing sexual harassment.

Staff is recommending the following changes to the Principles in response to the Board's direction (Attachment 2):

- Include a new principle B7 (d) in the Board Responsibility section on Corporate Culture
- Expand the Human Capital Management Practices principle B16 to include practices which focus on preventing discrimination including "harassment of any kind including, sexual harassment".

### Board Diversity

Following the direction of the Investment Committee on March 19, 2018, staff reviewed the Treasurer's request to amend CalPERS' Governance and Sustainability Principles to revise CalPERS' definition of a diverse board as one in which at least 30 percent of its members are women and 30 percent of its members are diverse in terms of sexual orientation and cultural and ethnic composition.

CalPERS' Principles state "board diversity should be thought of in terms of skill sets, gender, age, nationality, race, sexual orientation, gender identity, and historically under-represented groups." The Principles further state "consideration should go beyond the traditional notion of diversity to include a more broad range of experience, thoughts, perspectives, and competencies to help enable effective board leadership." CalPERS' definition of diversity is all-encompassing, and provides companies with the ability to include a level of diversity that fully reflects the company's business, its workforce, customer base and society in general. The Principles do not call for a quota for particular sections of the Board members as this could be viewed as arbitrary and limiting. For example, gender parity is a goal shared by many, but would require a higher proportion. Likewise, depending upon a company's location and markets, race and ethnic diversity definitions will vary.

CalPERS' view that diversity is multifaceted and complex is reflected in projects that support our board engagement, such as the Diverse Director DataSource (3D) and the Diversity and Inclusion priority in the ESG Strategic Plan.

There are various initiatives through governments and the private sector which focus on quotas or targets for board diversity, chiefly around gender. Two examples are the US based 30% Coalition and the UK based 30% Club, which now is expanding to other markets focusing upon management rather than boards. CalPERS has worked with each of these groups on different projects where there has been an opportunity to partner. However, given that our approach to board diversity is far more inclusive, and not just focused upon gender, we have not joined as members. We also have not adopted a quota approach to the issue of board diversity.

Nonetheless, staff continues to monitor opportunities to partner with others in support of efforts to ensure board diversity, where aligned with CalPERS' Principles.

Specifically, CalPERS supports the New York City Boardroom Accountability Project by providing proxy solicitation for shareowner proposals on proxy access. Proxy access gives shareowners the ability to ensure boards are independent, competent, diverse and accountable to shareowners. The selection criteria used to identify targeted companies focus on the following: diversity, climate related risk, compensation, and other governance concerns. In 2017, NYC launched the Boardroom Accountability Project 2.0 to enhance their current efforts. CalPERS supports the enhanced project by voting for these resolutions as they come to vote. The approach developed by New York City reflects the investor petition to the SEC around disclosure of board diversity which CalPERS led in partnership with North Carolina, CalSTRS and New York in 2016.

Meanwhile, as discussed at the March IC, in the coming proxy seasons, staff will:

- Vote against any combination of Board Chairs, Nominating & Governance Committee members, and long-tenured directors at companies that failed to adequately respond to our diversity engagement, following letters to over 500 US companies.
- File majority vote proposals at companies that lack diversity and vote against directors at these companies. This approach will go beyond targeting companies that failed to adequately respond to our engagement on board diversity.
- Engage asset owners and asset managers to explore developing market consensus around strategy to improve corporate diversity, as a component of enhancing board quality that will improve risk and return in the portfolio.

Based on these considerations, staff does not at this stage recommend including gender and race/ethnicity based targets for Board diversity in the CalPERS' Principles.

#### Updates to Enhance Accessibility:

Staff has recommended further minor revisions in line with CalPERS' broader efforts to increase accessibility to a wide variety of audiences. This includes providing reference to the California Constitution to explain CalPERS' fiduciary duty in the introduction of the Principles.

For consistency purposes, staff is also recommending to include 'loss of biodiversity' as a potential impact that a company can have on the environment in the recently proposed principles on Environmental Management Practices.

Attachment 2 provides the presentation containing the draft language for the Investment Committee's review. Attachments 3 and 4 contain draft versions for comment of the 2018 Governance and Sustainability Principles incorporating all the above changes as "tracked changes" and "clean" versions, respectively.

### **Budget and Fiscal Impacts**

Within existing budget

### **Benefits and Risks**

The Board's 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.

### **Attachments**

Attachment 1 – Council of Institutional Investors (CII) report, "How Corporate Boards Can Combat Sexual Harassment"

Attachment 2 – CalPERS' Governance & Sustainability Principles Presentation

Attachment 3 – CalPERS' 2017 Governance & Sustainability Principles (Tracked Changes View)

Attachment 4 – CalPERS' Governance & Sustainability Principles ("Clean" View)

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**Theodore Eliopoulos**

Chief Investment Officer