



Investment Committee

Item Number 8 – Open Session

Subject: Sustainable Investment & Stewardship Strategies – 2022 Stewardship Priorities, 2021 Highlights

Presenter(s): Chairperson

Item Type: Consent Information

Date & Time: January 27, 2022 – 0 minutes

Attachment(s): Attachment 1 – Stewardship Priorities

PowerPoint(s): None

POLICY

This item is covered under the CalSTRS [Sustainable Investment & Stewardship Strategies Program and Portfolio Policy](#) (Teachers' Retirement Board Policy Manual, Section 1000, C-1) and the [CalSTRS Corporate Governance Principles](#).

HISTORY OF THE ITEM

For several years, the Sustainable Investment & Stewardship Strategies Unit (SISS), formerly named the Corporate Governance Unit, prepared an Engagement Plan (the Plan) for the CalSTRS Board. Historically, the purpose of the Plan was to update the Board on environmental, social, and governance (ESG) engagements the team planned to undertake during the upcoming year and inform the Board about any shareholder proposals staff was considering. Since the first Engagement Plan, the market in which we operate as institutional investors has transformed dramatically, not only in the tools we have at our disposal to influence change, but also in the number of ESG issues that global investors focus on.

In January 2020, the Board approved the [CalSTRS Stewardship Priorities](#) (the Stewardship Priorities) to help prioritize and focus staff's activities on the most relevant issues for engagement that mitigate risk, support long-term value creation, and promote practices that provide for a sustainable financial market. The Stewardship Priorities also communicate to a wider audience including stakeholders, investment peers, and other market participants that have an interest in how CalSTRS uses our position as a large, long-term oriented asset owner to influence companies and policy makers.

PURPOSE

CalSTRS Stewardship Priorities were reaffirmed by the Board in January 2021 as a three-year plan. The longer approval cycle is more aligned with staff's ability to affect change and reflects the breadth and the relevance of the current priorities beyond one year. The Priorities are designed so staff can effectively use CalSTRS influence as a significant global investor to drive long-term value creation. Our stewardship activities are the primary means through which CalSTRS seeks to influence meaningful corporate and market change, leveraging our significant public equity ownership stakes in global companies.

When the Board agreed to a three-year plan, staff committed to report on the activities and tactics undertaken to implement the Stewardship Priorities. The purpose of this item is to inform the Board of achievements over the past calendar year and provide a framework for staff's engagement activities in 2022. Staff will continue to report quarterly through the [Value of Engagements](#) and inform the board on significant and high-profile engagement activities, in response to emerging situations, as needed.

DISCUSSION

CalSTRS has a long history of proactive engagement with portfolio companies on ESG issues that impact long-term company performance and with policy makers to ensure efficient markets and proper shareholder rights. Our thoughtful, analysis-based approach to engagement is well-respected in the global marketplace. This reputation, in addition, to our size, makes CalSTRS an attractive partner on a wide variety of initiatives. **This creates significant opportunities, but also requires the team to be able to prioritize and allocate resources appropriately, both to align with our goals, and to affect change where we have the greatest potential for success and the largest impact.**

Staff is also using this item as an opportunity to better align the Stewardship Priorities with the Net Zero Emissions Pledge (see agenda item 13). Staff is recommending we re-name the Low-Carbon Transition Stewardship priority as the Net Zero Transition Stewardship priority, since the Board adopted the pledge for the Investment portfolio in September 2021. Activities under this priority will continue to focus on supporting the global economy's efforts to mitigate and adapt to climate change.

As a reminder, the Board approved CalSTRS four Stewardship Priorities for 2021-2023:

- 1. Corporate and Market Accountability**

Encourage regulators, standard-setters and policy makers to promote sustainable markets with a focus on shareholder rights, audit integrity and sustainability-related disclosures.

- 2. Board Effectiveness**

Influence good governance with effective boards overseeing long-term strategies, including managing diversity, inclusion and human capital as well as executive compensation.

3. **Net Zero Transition**

Focus on supportive public policies and influencing companies on the path to a net zero economy.

4. **Responsible Firearms**

Address gun safety issues and aim to reduce investment risk, focused on manufacturers, retailers and technology.

Stewardship Priorities – 2021 Major Achievements

Corporate and Market Accountability

- **Companies will be required to provide better climate-related disclosure to investors:** CalSTRS continued to engage the U.S. Security and Exchange Commission (SEC) to mandate both universal and industry-specific climate disclosures to improve the information available to investors. We submitted a letter registering our support for mandated universal and industry-specific climate disclosures and supported an SEC mandate for companies of all sizes, and in all industries, to disclose both direct and indirect emissions, including upstream and downstream emissions. We asked for annual Task Force on Climate-Related Financial Disclosures (TCFD)-aligned reporting relating to a company’s governance, strategy, risk assessment, targets and metrics for managing the low-carbon transition to net zero emissions. The [final 2021 SEC rulemaking agenda](#), most notably, includes disclosure relating to climate risk, aligned with our requests.
- **Methane emissions (the most potent greenhouse gas) will be more tightly regulated:** The Environmental Protection Agency (EPA) proposed updates to the Clean Air Act to reduce methane emissions from the oil and natural gas industry. The rule comes after years of CalSTRS’ advocacy for tighter methane regulations. Most recently, CalSTRS signed a joint investor statement for ambitious methane regulation, and we directly engaged with the EPA in early October 2021. We encouraged the EPA to make low-production wells in scope for the rule since collectively they account for a significant portion of methane emissions. Previous rules only covered new wells, and while this is only a draft rule, it is a significant step to regulate wells that account for a significant portion of emissions. This comes on the heels of announcements made by President Biden at COP26, where he declared measures to reduce emissions from methane as one of the most important steps to meet climate goals.
- **Oversight of U.S. financial stability now includes climate change:** CalSTRS supported a federal bill jointly introduced to the House and Senate on March 3, 2021, to establish a climate risk advisory committee at the Financial Stability Oversight Council (FSOC or the Council). FSOC was established as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Council is significant because for the first time it provides comprehensive monitoring of the stability of our nation’s financial system. On October 21, 2021, FSOC issued a Report on Climate-Related Financial Risk which identified climate change as an emerging threat to U.S. financial stability. Among

the recommendations to member agencies are for them to collect climate risk data, enhance public disclosure requirements to include greenhouse gas emissions, and use scenario analysis to report on climate risk. We supported FSOC establishing a staff committee to support this work and the announcement of the formation of a Climate-related Financial Risk Advisory Committee to inform the group's work.

- **U.S. Department of Labor suspended a final rule undermining the links between ESG factors and investing, opposed by CalSTRS:** After engagement, the U.S. Department of Labor (DOL) suspended the enforcement of a final rule on ESG investments and proxy voting. The DOL heard from many stakeholders, including CalSTRS, on the proposed rule and its impacts. CalSTRS opposed the rule because it would have created a perception that retirement plans need special justification to consider ESG factors when making investments.
- **Consolidation of investor-oriented sustainability standards bolsters global standards for ESG reporting, including climate risk:** CalSTRS has long supported the SASB (Sustainability Standards Accounting Board) standards by founding and leading its Investor Advisory Group and through a leadership role on the SASB Standards Board. We welcomed the news that the SASB Standards will merge into the newly created International Sustainability Standards Board (ISSB) in a move that will consolidate a number of investor-oriented sustainability standard setters under the International Financial Reporting Standards (IFRS) Foundation. The ISSB plans to first release a climate reporting standard for a global baseline of climate risk reporting and follow with a broader set of sustainability standards including industry-specific standards. This development bodes well for more regulatory requirements for better climate and ESG disclosures in the global markets where we invest.

Board Effectiveness

- **Thirty Percent Coalition achieved strong results with 127 companies appointing women to their boards:** [The Thirty Percent Coalition](#) engaged more than 250 companies to request that diversity, inclusive of gender, race, and ethnicity be considered as a priority in board composition. Of the 127 companies appointing women to their boards, 65 companies, with all-male boards, appointed a woman and 62 companies appointed a second woman. SISS staff co-chair the Institutional Investors Committee of the Coalition, representing more than \$7 trillion in assets under management.
- **California Investors' efforts resulted in 13 women, 20 diverse women, and 36 diverse men appointed to boards:** The California Investors for Effective Board Diversity is a joint initiative with LACERA, CalPERS, CalSTRS and SFERS which expanded its focus from California headquartered companies to the S&P 500, with continued advocacy of diversity inclusive of gender, race, ethnicity and LGBTQ+ identity. The California group engaged 74 companies resulting in 41 companies appointing 13 women, 20 women from under-represented groups, and 36 men from under-represented groups.

- **Engagement of 50 global companies deeply affected by the pandemic identified important board best practices in overseeing human capital:** CalSTRS led the Pandemic Resilient 50 (PR-50) a group of ten like-minded institutional investors with approximately \$4 trillion in assets under management. As a result of engagement, the PR-50 identified and pressed for a set of board best practices including: 1) A plan for crisis management including contingency planning, 2) Aligning labor rights with local and global standards, 3) Adopting worker-focused practices such as paid sick leave, fair and living wages, and training and development programs, and 4) Establishing clear and specific goals for diversity, equity and inclusion.
- **Shareholders increased pressure at companies with misaligned pay and performance:** CalSTRS increased our against votes on Say-on-Pay (SOP) proposals from 15% in 2019 to 36% in 2021. In addition, through the 2021 proxy season, 60 companies did not get sufficient investor support for their SOP votes, an 11% increase over the same time period in 2020. While there is still much work to be done to better align pay with performance, investors are clearly demonstrating that that we are unwilling to accept the most egregious forms of pay. Many of the 2021 proposals failed because of special awards or Covid-related adjustments, which undermines the premise of pay-for-performance. The increase in failed SOP proposals sends a strong message to directors that shareholders will continue to be critical of these types of awards, which helps drive change and better pay-for-performance alignment.

Net Zero Transition

- **CalSTRS was instrumental in electing three new directors to the ExxonMobil board:** On May 26, 2021 shareholders delivered a resounding message to the management of ExxonMobil when they elected three directors to the board, nominated by investment manager, Engine No.1. CalSTRS brought immediate legitimacy to the proposed board candidates when we came out in support of Engine No. 1's campaign in December 2020. Over the past decade ExxonMobil has failed to evolve in a rapidly changing world, resulting in significant underperformance and risking further value destruction. CalSTRS, along with Engine No.1, articulated a clear case for reform and were central to sourcing new board candidates with specific expertise for a decarbonizing world. This victory is the outcome of a longer-running series of escalating engagement tactics at ExxonMobil, which includes a heightened and more targeted approach to engagement bringing about necessary and meaningful change. This historic win has broader implications beyond ExxonMobil, as it demonstrates that no company is too large or iconic to be the subject of shareholder discontent. When there is significant underperformance, shareholders will make their voice heard and hold directors accountable.
- **Eight Climate Action 100+ companies, led by CalSTRS, committed to reducing global emissions:** CalSTRS is a lead signatory of the [Climate Action 100+ \(CA100\)](#), an initiative of more than 600 investors with a goal to mitigate investment exposure to

climate risk and secure ongoing sustainable returns for their beneficiaries. Since CA100 launched, 111 companies have set net-zero commitments which equates to over a quarter of the global greenhouse gas emissions today. To date, CalSTRS is one of the most successful lead investors engaging businesses to cut emissions and accelerate the transition to net-zero emissions by 2050 or sooner.

- **Record number of shareholder proposals on climate got majority investor support:** Investors are growing more urgent in their demands that companies address business-relevant environmental risks as demonstrated in the record setting year in which 15 climate related proposals filed by Climate Action 100+ signatories received majority votes. CalSTRS submitted a shareholder proposal at Phillips 66 asking the oil and gas company to address concerns regarding corporate lobbying activities that are inconsistent with the Paris Agreement on climate change. Consistent with other proposals, the CalSTRS proposal received the support of 62% of shareholders. While Phillips 66 opposed our proposal, after it passed the Company became the first U.S.-based oil refiner to commit to lowering emissions from the use of the products it sells (Scope 3) by 2030 – validating the power of CalSTRS engagement.

Responsible Civilian Firearms

- **Largest firearms retailers established best practices on the sales of firearms:** CalSTRS continues to lead the Principles for a Responsible Civilian Firearms Industry, engaging the nation’s largest firearms retailers in the establishment of baseline best practices for the sale of firearms in the United States. Retailers agreed on best practices in the areas of background checks, transportation and storage of firearms, employee training, and customer education.
- **CalSTRS supported proposed regulations limiting the misuse of firearms:** CalSTRS submitted two separate letters to the Bureau on Alcohol, Tobacco, Firearms, and Explosives (ATF). Both letters supported regulators proposed rules to clarify the definition of a “frame or receiver” and “stabilizing braces” which would help limit the misuse of excessively dangerous weapons.

Stewardship Priorities: Framework for 2022 Engagement Activities

As discussed, the breadth of stewardship activities and the tools investors use to influence change have expanded dramatically over the last several years. In order to be successful and achieve meaningful outcomes, **staff intends to focus our efforts for the greatest level of impact.**

The goals below are staff’s main areas of focus and are not exhaustive of all activities. Along with direct company engagement, staff plans to utilize three main tools to achieve each goal: 1) Escalating our proxy votes to signal concerns to corporate management teams, 2) Collaborative engagements to scale global investor influence, and 3) Policy advocacy to change the ‘rules of the road’ that support long-term value creation. One or more of these tactics is used in each of the Stewardship Priorities described below to achieve the overall goal.

Corporate and Market Accountability: Advocate for mandated corporate disclosures on climate risks and human capital management.

1. Collaborative Engagements: Staff will continue to leverage investor coalitions to further the goal of mandated ESG disclosures, including climate change and human capital. CalSTRS will participate and provide leadership at the following organizations: Ceres, Sustainability Accounting Standards Board Investor Advisory Group, the Council of Institutional Investors, the Principles for Responsible Investment, and, for human capital specifically, the Human Capital Management Coalition.
2. Policy Advocacy: Staff expects the upcoming year to offer more opportunities to support stronger ESG disclosure and market accountability through strengthened regulatory requirements and enforcement. The [SEC's 2021 rulemaking agenda](#) suggests positive action in the areas CalSTRS has raised, and to meet the growing demand for comprehensive global sustainability disclosures staff will also engage the ISSB. 2022 will be a pivotal year for both the SEC and ISSB as they work toward universal disclosure standards, and CalSTRS will continue to make our voice heard.

Board Effectiveness: Expand board diversity beyond gender with a focus on improving overall human capital management practices.

1. Escalating Proxy Votes: CalSTRS will vote against more boards for lack of diversity. Diversity goals should include a mix of age, gender, sexual orientation and identification, cultural, racial, and ethnic composition. Over the past several years, CalSTRS has engaged hundreds of companies to improve diversity. Historically, we have only voted against directors after engagements have been unsuccessful. This year, staff will take a stronger stance and vote against the entire board if (i) there are no women on the board and (ii) against the nominating committee members if a company does not have at least 30% women board members or one woman and one diverse board member which represents at least 30% diverse members (gender, racial, ethnic diversity). We believe this is aligned with our long-term engagement efforts and the goal of the Thirty Percent Coalition.
2. Collaborative Engagements: CalSTRS participates and often leads collaborative organizations to improve board composition, governance, and specifically diversity, most notably through the Thirty Percent Coalition and the California Investors for Effective Board Diversity. CalSTRS is an active participant in both initiatives which allow us to leverage the power and resources of many like-minded investors. We will continue our participation to achieve results.
3. Policy Advocacy: The Human Capital Management Coalition (HCMC) is a critical partner for CalSTRS, which seeks to improve the management of human capital and worker rights through corporate board oversight and universal and industry-specific disclosures. CalSTRS will continue its participation with HCMC and leverage the power of this global network of investors.

Net Zero Transition: Establish a baseline for assessing portfolio companies' progress and alignment towards a net zero economy and escalate tactics against the highest emitting companies that fail to provide credible transition plans.

As discussed in agenda item 13, CalSTRS is first measuring our current portfolio emissions to establish a baseline and develop interim goals for the investment portfolio's net zero strategy. Similarly, with our net zero stewardship activities, we are evaluating current climate-related disclosures by companies to establish a baseline for assessing their strategic alignment with a net zero economy. There are currently no standardized disclosure requirements for climate risks and/or emissions and only emerging tools that help investors to comprehensively assess and benchmark different company progress towards net zero. CalSTRS will use the 2022 proxy season and our participation in two major collaborative investor initiatives (the [Climate Action 100+](#) and the [Transition Pathway Initiative](#)) to establish a heightened engagement plan based on companies' progress (or lack thereof) towards net zero.

The Transition Pathway Initiative (TPI) assesses companies' preparedness for the transition to a low-carbon economy and the Climate Action 100+ Net-Zero Company Benchmark assesses the performance of focus companies against three high level goals: emissions reduction, governance, and disclosure. Both investor tools rely on publicly available information, which can be vastly different around the world. While the scope continues to expand, current coverage is the largest emitting sectors and the largest companies by market capitalization in each sector.

Staff will update the Board on our targets for corporate engagement at the September board meeting as part of our one year Net Zero implementation plan.

1. Escalating Proxy Votes: CalSTRS will utilize the [Transition Pathway Initiative Tool](#) (TPI Tool) and the [Climate Action 100+ Benchmark](#) (CA100 benchmark) to identify laggard companies, specifically those companies that fail to disclose basic climate risks (Scope 1 and 2) and provide TCFD-aligned disclosures.

Scope 1 emissions are direct greenhouse emissions that occur from sources controlled by a company, and scope 2 emissions are indirect emissions associated with the purchase of electricity, steam, heating or cooling. Disclosure of both scope 1 and 2 emissions are metrics collected by the TPI Tool and the CA100 benchmark, but not all sectors and companies are currently covered.

Scope 1 and 2 emissions disclosures are necessary in order to establish a baseline for reduced emissions at any company or organization. As part of CalSTRS Net Zero pledge (and discussed in more detail in agenda item 13), it is critical that investors have basic disclosures from portfolio companies in order to measure and set targets to reduce the

emissions from our own portfolio. CalSTRS will utilize the CA 100 benchmark and TPI Tool to identify and vote against directors whose companies have failed to provide these basic disclosures to investors. We will vote against all directors, in high emitting industries, that do not provide this minimum level of disclosure.

In addition, CalSTRS will support all shareholder proposals that we believe better align a company's strategy with a net zero economy. Specifically, we will vote for all proposals that call for disclosure and measurement of Scope 1 and 2 emissions. This will support our longer-term need for more complete carbon emissions analysis in the public markets and push companies towards better carbon emissions management.

2. Collaborative Engagements: Staff, working with its partners in the Climate Action 100+ (CA100) initiative, will escalate tactics to increase pressure on the highest emitting companies. During the early years of Climate Action 100+, direct company engagement through meetings were the primary means used by members to influence companies. CA100 has broadened its engagement tools to include increased votes against directors and the submission of shareholder proposals. As stated, the 2021 proxy season was a record year for environmental proposals and the momentum will continue into 2022.
3. Policy Advocacy: The upcoming year will provide many opportunities to support increased disclosure on climate risk at the SEC and the ISSB. Staff is also collaborating with the Environmental Defense Fund (EDF) to enhance our public comments around rule changes and disclosure requirements that support a transition to net zero emissions by 2050, or sooner. Policies enacted this year will impact our ability to influence change in the future so our efforts and public comments will also be the basis for more comprehensive long-term policy-oriented efforts.

Responsible Civilian Firearms: Improve safety and risk of online transactions of ghost guns facilitated by credit card companies.

1. Collaborative Engagements: Staff will continue to lead the Principles for a Responsible Civilian Firearms Industry and encourage other investors to join. This year through our engagement with firearm experts, we learned that the sale of ghost guns (self-assembled firearms built from kits or individually purchased parts) is primarily conducted by small retailers, online retailers, and gun shows. We are directly engaging credit card companies that facilitate many firearms transactions to discuss safety and risk concerns, particularly those sales that occur online.
2. Policy Advocacy: Staff will continue to look for opportunities to engage the AFT to strengthen regulation on firearms and lower the risks to portfolio companies that facilitate the sales of firearms.