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LETTER FROM ILLINOIS TREASURER MICHAEL FRERICHS

Investing means making choices. For me and my team at the Illinois State Treasurer’s Office, it means choosing investments that are risk appropriate, high-performing, and responsible. It means making investments that not only strengthen the economic well-being of Illinois citizens and institutions, but making investments that reflect Illinois’ commitment to diversity, sustainability, and sound corporate governance.

Integrating ESG factors. That’s why we at the Treasurer’s Office are raising the bar. We endeavor to take governmental investment standards to a new level, one that recognizes that environmental, social, and governance (ESG) factors are strongly related to lower risk, better-performing investments.

Raising The Bar. Last fall we launched “Raising The Bar,” a program that puts this philosophy in practice. Over the past ten months, our office has been busy capitalizing on opportunities to grow our $25 billion investment portfolio while achieving results on ESG issues. We continue to actively engage corporate decision-makers, work in coalition with other institutional investors, vote by proxy, weigh in on public policy, and enthusiastically communicate the multifaceted benefits of responsible investing.

Getting Results. We are proud of the results we have achieved to date, highlights of which are below, and we look forward to presenting our constituents with regular updates on new efforts.

- Corporate Accountability: Wells Fargo—The Illinois Treasury successfully negotiated with executives at Wells Fargo to secure a policy that the Board of Directors be led by an independent Chair. The effort followed revelations that employees created as many as two million unauthorized accounts in response to a corporate culture obsessively focused on sales targets. Under previous governance rules, the former Wells Fargo CEO—who retired in the wake of the scandal—also served as Chair of the Board, effectively serving as his own boss.

- Risk Management: Wells Fargo—The Illinois Treasury suspended $30 billion in investment activity with Wells Fargo following the accounts scandal and further misconduct wherein the bank violated the rights of military personnel by seizing vehicles without a court order.

- Closing the Gender and Racial Divide: Board Diversity—The Illinois Treasury joined seven Midwest-based institutional investors to urge local companies to shake up their uniformly white male boards of directors by adding women and minorities. Seven firms adopted policies to create a pipeline for diverse candidates, and three appointed diverse board members.

- Income Inequality: Fighting for Fair Executive Compensation—The Illinois Treasury joined with 11 institutional investors to urge the outstanding 319 U.S. companies that only give shareholders a vote on their executive pay every three years to join the rest of the market by allowing investors a vote every year. The Illinois Treasury also voted against the compensation package for top executives at 131 companies where the pay was out of line with performance.

- Restoring Integrity to Public Discourse: Cracking Down on Fake News at Google and Facebook—The Illinois Treasury pressed social media companies to report on the epidemic of fake news and their progress working toward a solution that curbs the proliferation of fake news while protecting free speech.

- Independent Leadership—The Illinois Treasury threw out the rubber stamp on electing members to corporate boards. Since September, the Illinois Treasury has voted against 427 nominees that lacked independence, sat on too many boards to be effective, oversaw sustained weak performance, failed to show up for meetings, or acted counter to shareholders’ interests.

- Active Ownership—The Illinois Treasury has voted for 167 shareholder proposals at 156 corporations to support ESG reporting and actions.

For those keeping count, the Illinois Treasury voted on 3,755 proposals on corporate proxy ballots and separately reached out to 327 U.S. companies on ESG issues since September 2016. Each of these efforts helps advance the cause and protects our assets from the type of reckless behavior that can harm stock prices.

Why this matters. As a large, long-term investor in companies around the nation, we believe we can help raise the bar for the entire industry. That’s why we’re promoting an investment philosophy that fuses traditional investment objectives—safety of principal, optimal returns, and diversification—with a focus on corporate accountability, innovation, and the common good. By doing so, not only are we positioning ourselves for enhanced long-term returns, but we can help foster a business culture that is more accountable and attentive to the environmental, social, and governance values of the community. And that benefits all of us in Illinois and beyond.

For regular updates and more information on our responsible investing activities, visit www.IllinoisRaisingTheBar.com.

We hope you read on with interest about our endeavors.

Onward,

Michael Frerichs
AGENCY OVERVIEW—
THE ILLINOIS STATE TREASURER’S OFFICE

The Illinois State Treasurer is an independent constitutional officer elected by and directly accountable to the people of Illinois. Treasurer Frerichs serves as Illinois’ Chief Investment Officer and Chief Banking Officer. He and his team manage an investment portfolio of approximately $25 billion, which includes $12 billion in state funds, $8 billion in college savings plans, and $5 billion on behalf of state agencies and units of local government.

Treasurer Frerichs and his team are responsible for preserving the state’s investment portfolios, providing the necessary liquidity to meet liquidity demands, and consistently producing investment earnings that enrich the people and communities of Illinois.

The Treasurer’s Office also administers the state’s multiple banking functions and financial services, overseeing cash management activities, and processing payments and receipts on behalf of over 100 state agencies, boards, and commissions.

In addition, the Treasurer’s Office protects consumers by encouraging savings plans for college or trade school, providing savings plans for persons with blindness or disabilities, increasing financial education amongst people of all ages, removing barriers to a secure retirement, and returning unclaimed property to their rightful owners. The Treasurer’s Office fights to protect consumers from fraud, deception, and unfair practices, and it provides people in Illinois with the tools they need to achieve the American Dream.

When all is said and done, the Treasurer’s Office returns $28 to the state for every $1 spent in operations.

Treasurer Frerichs and his team are committed to fulfilling these objectives in a professional and ethical manner always striving for transparency, efficiency, and preservation of the public trust.

$28

The amount the Treasurer’s Office returns $28 to the state for every $1 spent in operations.
RAISING THE BAR—
OUR PLATFORM FOR RESPONSIBLE INVESTING

We know that to fulfill our fiduciary duty and maximize returns for the people of Illinois, we need to focus on more than just short-term gains and traditional indicators. Additional risk and value-added factors need to be integrated into the decision-making process to enhance the long-term value of our investments. These include environmental, social, and governance (ESG) factors.

Research agrees. Studies clearly demonstrate that companies with responsible ESG practices are lower risk investments and frequently provide collateral benefits to investors.\textsuperscript{1,2,3,4} So not only is ESG investing good for the community, it’s good for business. To put it another way, ESG integration aligns with our core fiduciary responsibilities.

The elements of ESG integration includes: investment policies, fund manager selection, proxy voting, due diligence, corporate engagements, and risk management.

ESG INTEGRATION: WHY IT MATTERS

- ESG Investment Strategy
- Corporations with Stronger Oversight
- Governance Risk
- Environmental Risk
- Social Risk
- Financial Risk
- Business Strategy
- Better Long-Term Performance
- Investment Returns

HIGHER STANDARDS
AND BETTER RESULTS

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- ESG Integration
  - Better Long-Term Performance
  - More Responsible Corporations
  - Advancing the Public Interest

- Traditional Investing
  - Conventional Risk Factors
  - Short Term Gains


**Environmental Factors**

Environmental stewardship is a shared responsibility. Corporations with poor or short-sighted environmental policies may face fines for environmental violations, supply-chain issues, or higher operating costs due to changes in environmental regulations. As such, environmental and climate-related factors may have adverse impacts on the Treasurer’s investment portfolio. Accordingly, we at the Treasurer’s Office recognize we must consider the following factors to mitigate our risk exposure.

- **Climate Change**—Climate change has serious risk implications for investors and the businesses in which they invest. Shifts in temperature, weather patterns, and rising sea levels impact supply chain, consumer demand, physical capital, and communities. Extreme weather events are occurring on a more frequent basis and with increasing intensity. Events such as droughts, floods, and storms may lead to scarce resources and disruptions in operations and workforce availability.

- **Sustainability**—Companies should consider how the environment and related regulation will impact operations and vice versa. Routine assessment of the nexus of operations, natural resource dependency, and the environment may be communicated to investors through sustainability reports. Quantitative reporting on environmental risks, policies, performance, and goals assures investors that companies are aware of potential risks and seeking to mitigate them appropriately.

- **Environmental Innovation**—A company’s awareness of environmental risks and opportunities may have a significant impact on its operational capacity, financial position, and long-term sustainability. With new environmental technologies, regulations, and business strategies rapidly developing (e.g., carbon pollution regulations and energy efficiency opportunities), it is important that companies maintain the knowledge and innovation to capitalize on these evolving changes. This may include, among other strategies, maintaining a board member or senior executive with expertise or ample experience with environmental science and technology.

**Social Factors**

Social factors may impact investment returns, particularly if companies become involved in controversies, compliance investigations, or lawsuits that pose risks to their reputation and ultimately to their bottom line. Human capital management, human rights, and community reinvestment are key social factors that warrant particular attention.

- **Human Capital Management**—Companies that consider their workforce to be an important asset should manage their human capital with as much care and analytical insight as they manage their physical and financial capital. The value of the workforce should be measured and improved through company investment. Employers also should respect the right of their workers to organize under collectively bargaining agreements. Employers should provide a working environment that upholds health and safety standards.
• **Human Rights**—Companies have a legal duty to adhere to internationally recognized labor and human rights standards. Beyond the legal requirements, companies risk losing their social license to operate if they contribute to human rights abuses throughout their supply chain. The United Nations’ “Guiding Principles on Business and Human Rights” sets out corporations’ responsibility to respect human rights. Companies should regularly assess and seek to minimize any negative impact caused by their operations.

• **Community Reinvestment**—The Treasurer’s Office seeks to encourage an open and effective banking system that grows local communities and boosts Illinois’ economy. Pursuant to the Deposit of State Moneys Act (15 ILCS 520/16.3), the Treasurer’s Office is authorized to consider a financial institution’s record and current level of financial commitment to its local community when deciding whether to deposit State funds in that financial institution. Accordingly, the Treasurer’s Office considers firms’ level of community reinvestment when undertaking investment decision-making.

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**Governance Factors**

An essential part of effective investment stewardship and risk management is identifying good governance practices. Good governance mitigates investment risks and may provide collateral benefits to the beneficiaries of the assets under the Treasurer’s stewardship. As such, the Treasurer’s Office recognizes and evaluates corporate investment opportunities by the following governance factors:

• **Board Accountability**—The board of directors is elected by the company’s shareowners and is accountable to them. The role of the board is to represent shareowners’ interests in their oversight of management. Industry best practice recognizes that the board of directors must maintain a level of independence from management to exercise proper oversight. The Treasurer’s Office considers an independent director to be one who:
  1. is not an executive of the company,
  2. does not have direct familial ties with executive management,
  3. does not have significant business ties to the company, and
  4. is not a significant shareholder.
• **Board Diversity**—Research demonstrates that a board comprised of diverse directors is better equipped to ensure multiple perspectives are taken into account. Diversity is inclusive of skill sets, professional backgrounds, gender, race/ethnicity, and LGBT.

• **Transparency**—With due respect to proprietary information, companies should strive to be transparent in their business operations. Disclosure concerning matters of shareowners’ interest, including ESG policies, provides useful information and mitigates risks inherent with undisclosed matters.

• **Fee Transparency**—Transparency and accuracy in the reporting of fees from service providers is also essential to secure competitive rates. The Treasurer’s Office endorses the Fee Reporting Template developed by the Institutional Limited Partners Association (ILPA). This reporting template captures greater detail on fees, expenses, and carried interest paid to General Partners and their affiliates. Not only does it enhance disclosures, but its broad endorsement helps increase uniformity in the field.

• **Sensible Executive Compensation Programs**—Excessive executive compensation programs may signal board entrenchment and exacerbate income inequality. Executive compensation should be reflective of company performance and be within a reasonable range of compensation levels at peer companies. In addition, an annual vote on executive compensation is a better option than a biennial or triennial vote because it affords shareholders the opportunity to provide the company’s compensation committees more timely feedback about the appropriateness of executive pay levels. Finally, companies should have “clawback” policies in place that enable them to recoup compensation later found to be unwarranted because of fraudulent activity or financial restatements.

• **Robust Shareholder Rights**—Shareholders should be given tools to convey their perspectives to the board of directors, which serves as their representative body. Tools that provide shareowners with the appropriate mechanisms for communication include the ability to:
  1. call a special meeting,
  2. act by written consent, and
  3. have access to the proxy to nominate their own candidate(s) for the board assuming certain threshold requirements.

In addition, a majority voting standard for the election of directors ensures that directors have the confidence of their constituents. Boards of directors should also be declassified to enable shareholders to weigh-in on each director on an annual basis.

• **Ethical Conduct**—Companies conducting business with or in receipt of investments from the Treasurer’s Office must comply with all laws and regulations under which they are governed. Further, the Treasurer’s Office expects companies to meet (if not exceed) all applicable ethical and professional standards of conduct.
A CASE STUDY IN SHAREHOLDER ADVOCACY

Wells Fargo

The rulemaking process through the Securities and Exchange Commission which regulates the capital markets is slow going. Dodd-Frank was signed into law in July 2010, and seven years later, many provisions are still in the rulemaking queue, including a provision to require companies have clawback policies, for example. Clawback policies permit companies to recoup executive compensation paid to executives as events warrant.

This is where institutional investors like the Treasurer’s Office come in. Institutional investors have a right—and some would argue a fiduciary obligation—to advocate for improved corporate governance by working directly with their portfolio companies. Through the direct engagement process, investors can advocate for certain safeguards and policies designed to reduce governance risks and improve long-term company performance. Companies may choose to take action in direct response.

Such was the case in 2013 with Wells Fargo. In that year, the New York City Comptroller Scott Stringer and the New York City pension funds (“NYCPF”) filed a shareholder proposal with the bank to urge it to adopt a clawback policy. Wells Fargo agreed and expanded policies to clawback executive bonuses in cases of misconduct. The Wells Fargo proposal was one of many filed by institutional investors. To date, 88 percent of the S&P500 has some form of a clawback policy, although most are limited to cases where there is a financial restatement.

In 2016, investigations revealed that Wells Fargo employees opened two million accounts using fictitious or unauthorized information. The bank paid $185 million in penalties and fines to settle cases with federal regulators and the Los Angeles city attorney. In the same month, Wells Fargo also paid $4.1 million to the U.S. Justice Department and $20 million to the U.S. Office of the Comptroller of the Currency to settle investigations into its unauthorized repossession of cars owned by members of the military. In total, it repossessed 413 cars without the necessary court order.

When the accounts scandal broke, the NYCPF reviewed the clawback policy it negotiated to see how it applied. NYCPF calculated that $60 million should be recouped from two executives. In a September 2016 letter, the City Comptroller Scott M. Stringer estimated that $19 million should be clawed back from the Head of Community Banking Carrie Tolstedt and $41 million should be clawed back from then-CEO John Stumpf. Five days later, The Wall Street Journal’s front-page headline read: “Wells Fargo Claws Back Millions From CEO After Scandal.” The company announced clawbacks of the exact same amounts estimated back at the pension fund offices.

This case illustrates the importance of setting up corporate governance safeguards prior to a scandal. It also highlights the importance of drafting explicit policies that ensure two offices running the numbers come up with the same total. The $60 million that otherwise would have gone to reward bad oversight stayed with the company and ultimately with shareholders. In its coverage of the clawback decision, The New York Times wrote: “The action represented one of the first times since the 2008 financial crisis that a chief executive has been forced to give up compensation.” Following the results of an independent investigation made public in April 2017, Wells Fargo took further action to clawback an additional $47 million from Tolstedt and $28 million from Stumpf.

Corporate Accountability: Wells Fargo

In the wake of the scandal, the Illinois Treasury filed a proposal asking Wells Fargo to create a policy requiring the Board Chair be independent. The proposal was co-filed with the Connecticut Office of the State Treasurer Denise L. Nappier and other institutional investors.

From 2010 until his abrupt departure, Stumpf had served as CEO and Chair of the Wells Fargo Board of Directors. The independent investigation revealed that in February 2014, while Stumpf sat as Board Chair, sales practices were identified as a noteworthy risk and brought to the Board’s attention in response to critical press of Wells Fargo’s practices in Los Angeles. A report to the Board indicated the risk had decreased by early 2015, but no mention was made of any data to support that conclusion or any further prodding by Board members until the company began to face lawsuits. The lack of pushback suggests the Board directors failed to challenge Stumpf’s assessment that the sales practices did not need fixing. While only those in the room know why pushback was scarce, one possible explanation is that the directors did not feel comfortable challenging the Chair.

Wells Fargo’s predatory and illegal banking practices proved that the company needed a set of independent eyes to ensure stronger, unbiased oversight. When the CEO also serves as Board Chair, essentially as his own boss, there is simply a lack of accountability at the highest level of the organization.

The position of the Council of Institutional Investors (CII), a nonprofit, nonpartisan association of 170 investors with $23 trillion in assets, is that an independent chair increases a boards’ ability to monitor management. “A CEO who also serves as chair can exert excessive influence on the board and its agenda, weakening the board’s oversight of management. Separating the chair and CEO positions reduces this conflict, and an independent chair provides the clearest separation of power between the CEO and the rest of the board,” according to CII.

The Offices of the Illinois and Connecticut Treasurers successfully negotiated with Wells Fargo to secure an independent chair that would head the Board going forward.
In addition to the shareholder advocacy effort at Wells Fargo, Treasurer Frerichs suspended $30 billion* in investment activity with the bank for one year, starting in October 2016. The Treasurer's Office took the following actions:

1. Suspension of investments in all Wells Fargo debt securities for one year;
2. Suspension of the use of Wells Fargo as a broker/dealer for the purchase of investments for one year; and
3. Authorized an audit to determine if improperly opening new bank accounts complied with Illinois law on returning unclaimed property to consumers.

*The $30 billion was calculated by how much of the state's investment portfolio passes through Wells Fargo in the course of a year. The amount is higher than the state's $25 billion portfolio because it includes dollars that eventually are spent to pay state bills or dollars that move through Wells Fargo before reaching another financial institution. In the course of a year, the Illinois Treasury is involved in approximately $1 trillion in banking transactions.

Commenting on the decision, Treasurer Frerichs said, “As the state’s chief banking and investment officer, I invest money on behalf of Illinois residents and units of local government. I look for institutions that offer good value to taxpayers and are good community partners. Wells Fargo’s acknowledgement of improper banking activity demonstrated a troubling business culture and a stunning lack of internal controls. For these reasons, I ordered a suspension of this investment activity. It was not a decision I took lightly. However, taking no action against one of the country’s largest banks was not acceptable. We must not reward those who blindly put profit over people.”

“We must not reward those who blindly put profit over people.”

–Michael Frerichs

IL TREASURER: STATE WILL SUSPEND WELLS FARGO BUSINESS Tri-County Times

BIG BANK IN FRERICHS’ DOG HOUSE Newsradio 1240 & 107.5 FM WTAX

FRERICHS SUSPENDS INVESTMENT ACTIVITY WITH WELLS FARGO Macomb News Now

ILLINOIS SUSPENDS $30B IN WELLS FARGO ACTIVITY; BANK ‘SORRY’ The Mecklenburg Times

ILLINOIS STATE TREASURER MICHAEL FRERICH’S SUSPENDED $30 BILLION IN STATE INVESTMENT ACTIVITY World News Report
ILLINOIS TREASURER’S ADDITIONAL SHAREHOLDER ADVOCACY EFFORTS

Income Inequality: Fighting for Fair Executive Compensation

Executive compensation may be a primary driver of economic inequality in the United States. In his acclaimed book, *Capital in the Twenty-First Century*, the economist Thomas Piketty makes the case that pay raises for executives are at fault for wider income inequality.

From the shareholder perspective, excessive executive pay is at worst a signal of a board that is overly accommodating to the CEO, or at best shows a lack of discipline in expending shareholder resources. The CII policy is that “executive compensation should be transparent and tied tightly to corporate performance, create value for the long-term and advance a company’s strategic goal.”

EPI pointed to the stark rise in the ratio from 1965, when the ratio was 20:1, which is a similar to the ratio found on other advanced economies. CEO pay has grown at 997 percent over the past 36 years, according to a 2016 report by As You Sow, a charitable organization focused on social corporate responsibility. As the authors of *The 100 Most Overpaid CEOs, Are Fund Managers Asleep at The Wheel* noted, this increase outpaced cost of living adjustments and the stock market and raises questions about whether CEO pay is reflective of company performance or spiraling upwards for extraneous reasons.

In an effort to create a check on runaway compensation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) provided shareholders with an advisory vote on executive compensation beginning in 2011. At that time companies also solicited shareholder input on whether say-on-pay votes should occur annually, biennially or triennially. Companies are required to put the so-called frequency vote out to shareholders every six years. The vast majority of Russell 3000 firms have say-on-pay votes annually. There are, however, notable exceptions.

The Illinois Treasurer’s Office joined a group of 11 other institutional investors and wrote to 318 Russell 3000 firms that do not have annual say-on-pay votes to ask that they move toward annual votes, a now well-recognized best practice. In 2017, companies that opted for a triennial say-on-pay vote must go back to the proxy to again ask shareholders how often they want to vote on executive compensation plans. The investors that wrote to the 318 firms to ask that they move to an annual schedule are: the Office of Investment for the AFL-CIO; Amalgamated Bank Longview Funds; Office of the State Treasurer of Connecticut; The Marco Consulting Group (now Segal Marco Advisors); Office of the New York State Comptroller; UAW Retiree Medical Benefits Trust; City of Kansas City, Missouri Firefighters’ Pension System; the National Cummings Foundation; Miami Firefighters’ Relief & Pension Fund; Office of the General Secretary-Treasurer International Brotherhood of Teamsters; and the International Union of Bricklayers & Allied Craftworkers. Results of the efforts will be announced once all of the 2017 proxy statements are made public.

In the United States, for each dollar the average employee earns, the CEO earns 303, according to a 2015 study by the Economic Policy Institute (“EPI”), a nonprofit, nonpartisan think tank.
**DIVERSITY’S DIVIDEND**

What’s the likelihood that companies in the top quartile for diversity financially outperform those in the bottom quartile?\(^1\)

15% 35%

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More likely to outperform:

- Gender-diverse companies
- Ethnically diverse companies

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\(^1\)Results show likelihood of financial performance above the national industry median. Analysis is based on composite data for all countries in the data set. Results vary by individual country.


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Investors prefer an annual vote because it affords shareholders the opportunity to provide a company’s compensation committee more timely feedback about the appropriateness of executive pay levels, which are typically decided on an annual basis. Also, literature on executive compensation indicates that annual say-on-pay votes increase management accountability to shareholders. A 2015 Columbia Business School study found, “compared to firms adopting an annual frequency, firms following management’s recommendation to adopt a triennial frequency are significantly less likely to change their compensation practices in response to an adverse say on pay vote, consistent with the notion that a less frequent vote results in lower management accountability” (Fabrizio Ferri and David Oesch, *Management Influence on Investors: Evidence from Shareholder Votes on the Frequency of Say on Pay*, Columbia Business School and University of Zurich, July 10, 2015).

A related concern is that firms’ generosity may shift in years where their compensation decisions will see an investor vote. For example, Expedia reported in its 2016 proxy statement when its compensation plans were not up for a shareholder vote that its CEO Dara Khosrowshahi received $94.6 million. This year when investors had a say-on-pay vote at Expedia the company paid the same CEO a total of $2.4 million, a stark drop.

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**Board Diversity**

The Illinois Treasurer’s Office moved the needle on efforts to increase racial and gender diversity among corporate boards. Fresh studies shored up earlier research that indicates a correlation between diversity and performance. A January 2015 study by McKinsey & Company, *Why Diversity Matters*, found companies in the top quartile for gender or racial and ethnic diversity tend to report financial returns above their national industry medians. Credit Suisse came to similar conclusions in its study, *Women’s Positive Impact on Corporate Performance*. The financial services firm found, “greater gender diversity in companies’ management coincides with improved corporate financial performance and higher stock market valuations.” An activist hedge fund, Ides Capital, is seeking to capitalize off that research by employing a strategy to diversify small and midsize corporate boardrooms as a way to help improve stock prices.
Despite these movements, the reality is women and racial minorities are still significantly underrepresented in American boardrooms. A report by the Alliance for Board Diversity in collaboration with Deloitte found that in 2016, minorities (African American, Asian/Pacific Islanders and Hispanics/Latinos) held fewer than 15 percent of board seats among Fortune 500 firms. Of the 810 Fortune 1000 companies studied by the advocacy organization 2020 Women on Boards, women now comprise 19.7 percent of board seats, up from 18.8 percent in 2015 and 14.6 percent in 2011. Still, at this current rate it will take more than four decades for women to reach parity, per a U.S. Government Accountability Office report, Corporate Boards: Strategies to Address Representation of Women Include Federal Disclosure Requirements.

The Treasurer’s Office joined The Thirty Percent Coalition, a collection investors, public officials, nonprofits, companies and professional firms founded in 2011 to increase the number of women on public company boards. The vision of the 80-member group is that corporate boardrooms will reflect the gender, racial and ethnic diversity of the United States work force. In addition, the Treasurer’s Office joined with local investors to make an impact at companies close to home.

The Treasurer’s Office helped launch the Midwest Diversity Initiative in 2016 to advance diversity at Midwest companies. Local institutional investors representing $275 billion in assets (including the Ohio Public Employees Retirement System; SEIU Master Trust; State of Wisconsin Investment Board; Sundance Family Foundation; Marco Consulting Group [now Segal Marco Advisors]; and Trinity Health) reached out to 17 local companies with lagard diversity levels. Seven firms changed their corporate governance policies to explicitly consider race, ethnicity and gender when recruiting new board members, including: Knowles Corporation, Itasca, Ill.; Littelfuse, Inc., Chicago; Marten Transport Inc., Mondovi, Wis.; SPS Commerce, Minneapolis; and TransDigm Group Inc., Cleveland, Ohio.

The Diversity Initiative was pleased to see that three additional companies appointed diverse directors to their boards in 2016: A. Schulman in Fairlawn, Ohio, and Rockwell Medical Technology Group in Wixom, Mich.
Restoring Integrity to Public Discourse:
Cracking Down on Fake News at Alphabet and Facebook

In 2016, Oxford Dictionaries selected the term “post-truth” as its word of the year, which it defined as “relating to or denoting circumstances in which objective facts are less influential in shaping public opinion than appeals to emotional or personal belief.”

With more and more citizens being subjected to systematic deception and manipulation online, the proliferation of fake news represents a major threat to our democratic institutions and the public’s understanding of current events. Treasurer Frerichs firmly believes that internet platforms need to step up and acknowledge their corporate responsibilities.

Furthermore, as an institutional investor and steward of public resources, the Treasurer’s Office is concerned that Facebook and Google’s role in the distribution of fake news could hurt shareholder value. If people lose trust and confidence in major information brokers like Facebook and Google, they may move on to other service providers. That presents a risk to long-term investors—and investors have a right to know that companies are tackling this problem in a responsible manner.

Investors and social media platforms need to come together and develop solutions that protect public and business interests. In an extensive report, Fake News, Hate Speech & Free Expression: Corporate Responsibility in an Age of Alternative Facts, by Open Mic—a non-profit focused on media issues, the authors wrote, “Investors have also taken note and are asking tech companies to report on how they are handling the challenges presented by various forms of objectionable content.”

In that same report, social media companies are described as “brokers of content and truth on a global scale.” Alphabet (Google) and Facebook originally rejected this role, instead viewing themselves as agnostic platforms where information is simply generated and shared by users. The fact of the matter is that social media platforms clearly maintain an editorial role in establishing and enforcing standards for what content is published and widely distributed on their platforms.

The Treasurer’s Office wrote both firms in April 2017 ahead of their shareholder meetings to urge them to respond to the problems fake news ignites with a transparent and inclusive discussion with stakeholders about solutions. The Treasurer’s Office attended the 2017 Facebook annual shareholder meeting and voted in favor of a proposal filed by Arjuna Capital in partnership with the Baldwin Brothers that requested the company issue a report on actions taken on fake news.
COMMITMENT TO ENVIRONMENTAL STEWARDSHIP, CLIMATE SOLUTIONS, AND SUSTAINABILITY

Research clearly demonstrates that companies with responsible environmental policies and practices are lower risk investments and often provide material benefits to investors. Consider the investment risks associated with various environmental factors.

Studies show that shifts in temperature, weather patterns, and rising sea levels impact supply chains, consumer demand, physical capital, and vulnerable communities. Take the agricultural industry, for example. A 2014 study by researchers at UC Berkeley and the University of Illinois found that daily crop yields in U.S. counties typically decline by 1.7% for each 1°C rise in average temperatures above 59°F. As such, companies need to account for this plausible disruption, assess their nexus of operations, and pursue strategies that mitigate their risk exposure.

As investors, we know that corporations with poor or short-sighted environmental policies are more likely to face fines, supply chain issues, higher operating costs, or reputational risks. These risks may have adverse impacts on investment returns, especially in the long-term.

That's why we at the Treasurer's Office are raising the bar and taking a number of actions to operationalize this focus:

- **Evaluating All Investments by Environmental Impacts**—The Treasurer’s Office changed its investment policies and developed a specific ESG Investment Policy that formally establishes environmental factors as part of our risk analysis and investment decision-making processes.

- **Investing in Green Bonds**—Investing in environmental-impact notes results in monetary and societal benefits. As a result, the Treasurer’s Office has invested $10 million in green bonds, proceeds which are used to fund investments in the productive use of renewable energy, sustainable forestry, energy efficiency, energy optimization, and the production of clean energy sources.

- **Investing in Green Technology Companies**—As a part of the Illinois Growth and Innovation Fund (ILGIF), which invests $222 million in funds positioned to provide capital to Illinois technology companies, the Treasurer’s Office seeks to utilize fund managers that have demonstrated experience and/or an express ability to invest in green technology businesses in Illinois.

- **Calvert Equity Portfolio**—Individuals and families using the Treasurer’s Bright Directions College Savings Program have the opportunity to invest in a mutual fund, Calvert Equity Portfolio, that is specially tailored to support responsible investing. Investments in this fund are judged by their ESG performance. And not only does this help promote responsible ESG best practices, but this assessment helps inform risk and opportunity factors that may impact performance.
TREASURER FRERICH'S FOCUS ON DIVERSE AND ILLINOIS-BASED BUSINESSES

Increasing Utilization of Diverse Investment Partners

Diversity and inclusion are core pillars of the Treasurer’s approach to investing. Research demonstrates that diverse companies—those owned by minorities, women, military veterans, or disabled (MWVD) individuals—are well-situated to ascertain capital inefficiencies in the market, and as such, many are primed to outperform their peers. That being the case, Treasurer Frerichs has transformed the culture, policies, and operations of the Treasury to enhance opportunities available to MWVD individuals and business partners.

The Treasury’s two internally managed investment programs, the State Investment Portfolio and The Illinois Funds, are made up of direct purchases and brokered assets. Together these two programs hold approximately $18 billion in assets (as of May 2017). Tapping broker/dealers is one of the quickest and best ways to boost MWVD participation.

Since Treasurer Frerichs came into office, the Illinois Treasury has increased utilization of MWVD broker/dealers from 1% to 63%. Put another way, in FY 2014, total assets brokered with MWVD firms was $603 million. In FY 2017, total assets brokered with MWVD firms was $24 billion. That represents a 40-fold increase. And this progress has been achieved with no additional cost to the state.

Treasurer Frerichs has put extensive effort into expanding the use of MWVD asset managers as well. In January 2015, when Treasurer Frerichs came into office, the Treasury had $16 million with MWVD fund managers. As of May 2017, the Treasury had $178 million with MWVD managers. That represents an 11-fold increase, with greater gains anticipated in the future.

Increasing Utilization of Illinois-Based Investment Partners

Treasurer Frerichs is dedicated to growing Illinois’ economy. That means supporting Illinois businesses, giving them the opportunities they need to create jobs and prosper. This focus applies to the firms the Treasury uses for brokerage, asset management, and other investment services.

In FY 2017, over $120 billion was brokered by investment firms based in Illinois.

On the asset management front, as of May 2017, the Illinois Treasury had over $645 million with Illinois-based firms. In January 2015, when Treasurer Frerichs came into office, the Treasury had approximately $406 million with Illinois-based firms. That represents a 59% increase, with greater gains anticipated in the future.
ON THE LEGISLATIVE FRONT

The Financial Choice Act of 2017

The U.S. House of Representatives passed legislation on June 8, 2017, that would strip investors of their tools to engage companies. The Senate looks unlikely to take up a vote without a filibuster-proof 60 votes in support. However investors are concerned portions of the bill could advance through other legislative initiatives. Treasurer Frederichs wrote to the Illinois Congressional Delegation in advance of the vote to urge their opposition.

Treasurer Frederichs also joined with 13 other state treasurers across the country to defend shareholder rights in a joint statement to Congress. The letter defended the current regulatory framework that provides investors with tools to engage companies on ESG matters.

The Treasurer’s Office wrote to the U.S. Securities and Exchange Commission in March 2017 along with more than 100 investors representing a total of $3 trillion in assets, to express support for a provision of Dodd-Frank. The pay ratio disclose rule required U.S. listed companies to report on the ratio of pay to their CEO compared to that of the median worker. The reporting is scheduled to begin in January 2018 unless the SEC delays implementation or Congress reverses the provision.
The Treasurer’s Office votes its proxies in line with the Proxy Policy Statement available on page X of this report. Since September 2016, the Treasurer’s Office has voted 3,755 proposals at 304 companies. A full list of the votes cast is available on the Treasurer’s Raising The Bar website (www.IllinoisRaisingTheBar.com).

Several of the votes were identified by two organizations that track proxy votes closely. The AFL-CIO identifies key votes on an annual basis and reports on how funds voted on the issues. The National Conference on Public Employee Retirement Systems, the largest association for public sector plans, also identifies key proxy votes. Those key vote lists and how the Treasurer’s Office voted are provided below.

### AFL-CIO KEY VOTES - 2017 PROXY SEASON

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<td>Amazon.com, Inc.</td>
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<td>Exxon Mobil Corp.</td>
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<td>No Share Position</td>
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<td>FleetCor Technologies, Inc.</td>
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<td>Hospitality Properties Trust</td>
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<td>JPMorgan Chase &amp; Co.</td>
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<td>Mondelez International, Inc.</td>
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<td>Netflix, Inc.</td>
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<td>Reynolds American Inc.</td>
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<td>SL Green Realty Corp.</td>
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<td>For</td>
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<td>Skechers U.S.A., Inc.</td>
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<td>Wal-Mart Stores, Inc.</td>
<td>Independent Chair</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Wells Fargo &amp; Company</td>
<td>Report on Retail Banking Sales Practices</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>XPO Logistics, Inc.</td>
<td>Report on Sustainability</td>
<td>For</td>
<td>For</td>
</tr>
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</table>
Proposals land on company ballots through one of two avenues: either management puts forward a proposal to comply with legal requirements or to gauge shareholder sentiment, or investors that meet a certain threshold submit a proposal to the company. The three most commonly voted proposals in both categories—shareholder proposals and management proposals—are described below. A statistical report on the Treasurer’s voting is noted at the end of this section.

A glance at the top three most common management proposals voted

ELECTION OF DIRECTORS
The Treasurer’s Office votes against nominees for corporate directorships for the following reasons:

- Weak relative financial performance over a sustained period.
- The board has less than two-thirds independent directors or insiders sit on key board committees.
- The board took an egregious action that is adverse to shareholder interests.
- A director failed to attend fewer than 75 percent of board and committee meetings without providing a valid explanation for the absence.

2,495
the number of proposals the Treasurer’s Office voted on to elect directors of companies in 2017

82%
the percentage of those 2,495 proposals that the Treasurer’s Office supported
276
the number of proposals the Treasurer’s Office voted on to ratify auditors of companies in 2017

63%
the percentage of those 276 proposals that the Treasurer’s Office supported

RATIFICATION OF AUDITORS
In 2001, the SEC began requiring companies to disclose how much they paid their accountants for both audit and non-audit work in the prior year. The disclosures revealed that many companies were paying their auditors three times more for “other” work than for their audit work. The 2002 Sarbanes-Oxley Act (“SOX”) limited the auditor conflict issue, although auditors are still permitted to perform tax and other non-audit related services for companies they audit. The vote to ratify auditors is in favor unless auditors receive substantial enough sums for non-audit services that it poses a potential conflict of interest for an independent audit.

ADVISORY VOTE ON EXECUTIVE COMPENSATION
Dodd-Frank provides shareholders with an advisory vote on executive compensation. The following factors are weighed:

• Alignment: Company performance and compensation amounts should compare favorably relative to its peer group.

• Stock Awards: Performance-based stock awards drive superior performance as compared to time-vested awards that are paid out regardless of performance.

• Dilution: The dilution to current shareholder equity should not exceed 5 percent.

• Severance Payments: A company should not provide severance pay-out that qualifies as a golden parachute under the IRC Code. A company also should not gross-up excise taxes owed by the executive in receipt of golden parachute payments.

278
the number of proposals the Treasurer’s Office voted on to approve executive compensation arrangements

52%
the percentage of those 278 proposals that the Treasurer’s Office supported
A glance at the top three most common shareholder proposals voted

CALL SPECIAL MEETINGS
Shareholders with the right to call a special meeting have an additional tool for weighing in on critical issues. The corporate laws of some states (although not Delaware where most companies are incorporated) provide that the holders of 10 percent of the outstanding shares may call a special meeting of shareholders, absent a contrary provision in the company’s charter or bylaws. Most companies’ charters or bylaws only grant the board of directors the ability to call a special meeting of shareholders—typically to consider a merger or acquisition. Australia, Canada and the United Kingdom have corporate laws that allow shareholders to call special meetings. These proposals ask companies to amend their bylaws to establish a process by which the holders of 10 percent to 25 percent of outstanding shares may call a special meeting.

11
the number of proposals the Treasurer’s Office voted on to give shareholders the ability to call a special meeting

100%
the percentage of those 11 proposals that the Treasurer’s Office supported

INDEPENDENT BOARD CHAIR
The chairman of the board supervises and monitors the executives that manage the company on behalf of shareholders. When a chairman is the chief executive officer or has close ties to the CEO or the other principal executives officers a potential conflict of interest is inherent.

16
the number of proposals the Treasurer’s Office voted on to require the chair be in an independent director

100%
the percentage of those 16 proposals that the Treasurer’s Office supported
POLITICAL CONTRIBUTIONS AND LOBBYING DISCLOSURE

A wide coalition of institutional investors has been filing proposals seeking disclosure on corporate political spending for more than a decade. More than 300 firms and half of the S&P 500 companies now provide disclosure about their political spending directly on their websites. Shareholders argue boards of directors should oversee the corporate political spending to ensure it supports corporate goals and priorities. Advocates of the disclosure argue companies will better weigh the benefits and risks of political spending when the reporting is public.
PROXY POLICY STATEMENT

Our policy is designed to reflect the fiduciary duty to vote proxies in favor of shareholder interests. In determining our vote, we will not subordinate the economic interest of the plan participants to any other entity or interested party.

Per the terms of ERISA, we will “cast the (client’s) proxies in a timely manner solely in the interests of the participants and beneficiaries of (client’s) Plan for the exclusive purpose for providing benefits to participants and their beneficiaries and defraying the reasonable expenses of administering the Plan with care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity familiar with such matters would use in the conduct of an enterprise of like character and with like aims in accordance with the documents and instruments governing the Plan in accord with the provisions of ERISA.”

Numerous studies and surveys of leading institutional investors demonstrate the value of good corporate governance. Below are references to relevant sources.

Specifically:

- A 2015 Columbia Business School study, “Management Influence on Investors: Evidence from Shareholder Votes on the Frequency of Say on Pay,” found, “[c]ompared to firms adopting an annual frequency, firms following management’s recommendation to adopt a triennial frequency are significantly less likely to change their compensation practices in response to an adverse say on pay vote, consistent with the notion that a less frequent vote results in lower management accountability.”

- A January 2015 study by McKinsey & Company, “Why Diversity Matters,” found companies in the top quartile for gender or racial and ethnic diversity tend to report financial returns above their national industry medians.

- Credit Suisse came to similar conclusions in its 2014 study, “Women’s Positive Impact on Corporate Performance.” The financial services firm found “Greater gender diversity in companies’ management coincides with improved corporate financial performance and higher stock market valuations.”

- A 2015 study by professors at The Wharton School and Boston College, Passive Investors, Not Passive Owners, that found passively managed mutual funds exert influence on firms’ governance. The research also found the significant governance changes associated with the funds such as more independent directors, removal of takeover defenses and more equal voting rights improve firms’ long-term performance.

- A survey in 2000 by the World Bank of 200 institutional investors in the U.S., Europe, Asia and Latin America whose aggregate assets were valued at $3.25 trillion revealed that 75% of the respondents considered corporate governance to be at least as important as financial performance when evaluating assets and 80% said they would pay more for shares of a well-governed company than a poorly-governed company with comparable financials. The good governance factors were: a majority of independent directors; formal evaluations of directors; company responsiveness to requests on governance issues; directors holding significant shares of the company; and a large portion of director compensation being paid in stock.

- A 2003 study of 1,600 major U.S. and foreign companies by Governance Metrics International that assessed businesses on 600 criteria (e.g., auditor independence, conflict of interest among top executives, potential share dilution from stock options, board independence, financial disclosure and internal controls) found that over three years, companies with the poorest governance ratings lost an average of 13% a year compared with a loss of 1.8% for all companies. Companies with good governance ratings beat those rated near the bottom for periods of over five and 10 years. The study concluded that superior governance does not necessarily generate superior returns, but inferior governance does evidence inferior returns.

- A 2003 study in the Quarterly Journal of Economics, “Corporate Governance and Equity Prices,” found that those firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth and lower capital expenditures.
• A 2004 Harvard University study found that classified boards are correlated with an economically significant reduction in firm value. The study applied a standard financial economic measure known as Tobin’s Q (market value of assets divided by their book value) to more than 1,400 companies accounting for more than 90% of the total capitalization of the U.S. stock market. Having a classified board reduced a company’s Tobin’s Q value by an average of three to four per cent.

• A 2004 study in Financial Analysts Journal found that as the number of outside directors on board and key committees increased, the likelihood of misdeeds decreased, which lends support to the corporate governance activists who argue that a substantial majority of independent outsiders is needed on boards to protect shareholders, not just the simple majority in the listing requirements of the New York Stock Exchange and NASDAQ. The study compared 133 companies accused of fraud from 1978-2001 with another sample of 133 no-fraud companies of similar size and in the same industries.

• In 2005, an Institutional Shareholder Services study showed that companies with better corporate governance outperformed poorly-governed companies in return on investment, annual dividend yield, net profit margin and price-to-earnings ratio.

• In 2006, Institutional Shareholder Services surveyed more than 300 large investors overseeing $10.5 trillion in assets in 19 countries and found that: 94% of investors view corporate governance as critical to their companies; 63% think corporate governance will become even more critical over the next three years; 67% believe that corporate governance offers value; and 58% think that corporate governance enhances investment returns.

• A 2007 study by Governance Metrics that graded the S&P 500 companies on more than 400 corporate governance variables as well as their stock performance from July 1, 2003 through June 30, 2006, found that those companies that were graded above average on corporate governance outperformed the S&P 500 in total shareholder return (13.46% to 11.32%) and those companies with below average corporate governance ratings underperformed the S&P 500 (10.53% to 11.32%).

• A 2007 study by Wilshire Consulting for the California Public Employees’ Retirement System (CalPERS) showed that of the 128 poorly performing focus list companies CalPERS engaged from 1987-2005 to improve their corporate governance: the companies underperformed their respective benchmarks by 86.7% for the five years preceding CalPERS activism; the companies outperformed their respective benchmarks by 12.2% for the subsequent five-year period.

• In 2007, Institutional Shareholder Services attributed shareholder activism with creating $3.3 billion in additional value for Caremark shareholders by forcing CVS to restructure its acquisition of Caremark.

Each proxy will be reviewed on a case-by-case basis with final decisions based on the merits of each case. In reviewing the proxy issues, we will use the following Issue Guidelines for each of the categories of issues listed below.

Issue Guidelines

ELECTION OF DIRECTORS

The members of the boards of directors are elected by shareholders to represent the shareholders’ interests. This representation is most likely to occur if two-thirds of the members are independent outsiders as opposed to insider directors (such as senior management employees, former employees, relatives of management or contractors with the company). If two-thirds of the board is not represented by independent outsiders, a vote will usually be cast to withhold authority on the inside directors.

Other factors that will be considered when reviewing candidates will be the diversity of board nominees in terms of race, gender, experience and expertise; the number of corporate boards on which they already serve (ideally directors with fulltime jobs should serve on no more than three other boards and no individual should serve on more than five other boards), whether they have pledged a substantial amount of company stock, their performance on committees and other boards, the company’s short-term and long-term financial performance under the incumbent
candidates, the company’s responsiveness to shareholder concerns (particularly the responsiveness to shareholder proposals that were approved by a majority of shareholders in the past 12 months) and other important corporate constituents, the overall conduct of the company (e.g., excessive executive compensation, adopting anti-takeover provisions without shareholder approval) and not attending at least 75% of Board and Committee meetings unless there is a valid excuse.

Recently, more emphasis has been placed on the independence of key Board committees—audit, compensation and nominating committees. It is in the best interests of shareholders for only independent directors to serve on these committees. Votes will be withheld from any insider nominee who serves on these committees.

In contested elections of directors, the competing slates will be evaluated upon the personal qualifications of the candidates, the quality of the strategic plan they advance to enhance long-term corporate value, management’s historical track record, the background to the proxy contest and the equity ownership positions of individual directors.

RATIFICATION OF AUDITORS

The ratification of auditors used to be universally considered a routine proposal, but a disturbing series of audit scandals at publicly-traded companies and SEC-mandated disclosures that revealed auditors were being paid much more for “other” work at companies in addition to their “audit” work have demonstrated that the ratification of auditors needs to be scrutinized as much as the election of directors.

Although the Sarbanes-Oxley Act of 2002 attempted to address the issue of auditor conflicts of interest, it still allows auditors to do substantial “other” work (primarily in the area of taxes) for companies that they audit. Therefore, the amount of the non-audit work will be weighed and if it is so substantial as to give rise to a conflict of interest, a vote will be cast against the ratification of auditors. Concern will be raised if the non-audit work is more than 20% of the total fees paid to the auditors. Other factors to weigh will be if the auditors provide tax avoidance strategies, the reasons for any change in prior auditors by the company, and if the same firm has audited the company for more than seven years.

ROUTINE PROPOSALS

Routine proposals are most commonly defined as those which do not change the structure, by laws, or operation of the company to the detriment of the shareholders. Traditionally, these issues include:

• Indemnification provisions for directors;
• Liability limitations of directors;
• Stock splits/reverse stock splits;
• Name changes.

Given the routine nature of these proposals, proxies will usually be voted with management. However, each will be examined carefully. For example, limitations on directors’ liability will be analyzed to ensure that the provisions conform with the law and do not affect their liability for such actions as the receipts of improper personal benefits or the breach of their duty of loyalty. The analysis of a proposal to limit directors’ liability would also take into consideration whether any litigation is pending against current board members.

NON-Routine PROPOSALS

Issues in this category are more likely to affect the structure and operation of the company and, therefore will have a greater impact on the value of a shareholder’s investment. We will review each issue in this category on case-by-case basis.

As previously stated, voting decisions will be made based on the financial interest of the plan beneficiaries. Non-routine matters include:

Mergers/Acquisitions and Restructuring (See also Reincorporating/Inversions)
Our analysis will focus on the strategic justifications for the transaction and the fairness of any costs incurred.

Advisory Votes on Compensation Policies and Practices
To evaluate compensation policies and practices, the threshold query is “does a company’s compensation reflect its performance”? This will be determined by how a company has performed for shareholders compared to its peer group as well as by how a company has compensated its executives compared to its peer group. Whether restricted stock awards are time vesting or performance vesting will also be taken into consideration. Additional queries will be made to determine the level of dilution in stock compensation plans, and to ascertain if golden parachutes have been awarded to executives and, if they have, whether they pay tax gross-ups. The threshold query will carry the most weight, but the additional queries can be persuasive in the event the answer to the threshold query is not clear cut. There will also be an option as to whether the company should have these advisory votes on compensation on an annual basis or every two or three years. An annual basis is in the best interests of shareholders.

Advisory Votes on Severance Packages In Connection with Mergers/Acquisitions
The factors to weigh are whether the total payment is in excess of 2.99 times salary and bonus, whether excise taxes are grossed-up, if there is a double trigger for cash payments and whether the accelerated vesting of stock awards is excessive.

Fair-Price Provisions
These attempts to guard against two-tiered tender offers in which some shareholders receive less value for their stock than other shareholders from a bidder who seeks to take a controlling interest in the company. There can be an impact on the long-term value of holdings in the event shareholders do not tender. Such provisions must be analyzed on a case-by-case basis.

Reincorporating/Inversions
A company usually changes the state or country of its incorporation to take advantage of tax and corporate laws in the new state or country. These advantages should be clear and convincing and be supported by specific, legitimate business justifications that will enhance the company’s long-term value to shareholders and will be weighed along with any loss in shareholder rights and protections (e.g., dilution of management accountability and liability, anti-takeover devices), reputational risk, damage to governmental relationships, adverse impact on the company’s employees and erosion of the local/state/Federal tax base.

Changes in Capitalization
Our inquiry will study whether the change is necessary and beneficial in long run to shareholders. Creation of blank check preferred stock, which gives the board broad powers to establish voting, dividend and other rights without shareholder review, will be opposed.

Increase in Preferred and Common Stock
Such increases can cause significant dilution to current shareholder equity and can be used to deter acquisitions that would be beneficial to shareholders. We will determine if any such increases have a specific, justified purpose and if the amounts of the increase are excessive.

Stock/Executive Compensation Plans
The purpose of such plans should be to reward employees or directors for superior performance in carrying out their responsibilities and to encourage the same performance in the future. Consequently, the plan should specify that awards are based on the executive’s/director’s and the company’s performance. In the case of directors, their attendance at meetings should also be a requirement. In evaluating such plans we will also consider whether the amount of the shares cause significant dilution (5% or more) to current shareholder equity, how broad-based and concentrated the grant rates are, if there are holding periods, if the shares are sold at less than fair market value, if the plan contains change-in-control provisions that deter acquisitions, if the plan has a reload feature, and if the plan allow the repricing of “underwater” options.
Employee Stock Purchase Plans
These are broad-based plans, federally regulated plans which allow almost all fulltime and some part-time workers to purchase limited amounts of company stock at a slight discount. Usually the amount of dilution is extremely small. They will normally be supported because they do give workers an equity interest in the company and better align their interests with shareholders.

Creation of Tracking Stock
Tracking stock is designed to reflect the performance of a particular business segment. The problem with tracking stocks is they can create substantial conflicts of interest between shareholders, board members and management. Such proposals must be carefully scrutinized and they should be supported only if a company makes a compelling justification for them.

Approving Other Business
Some companies seek shareholder approval of management being given broad authority to take action at a meeting without shareholder consent. Such proposals are not in the best interests of shareholders and will be opposed.

CORPORATE GOVERNANCE PROPOSALS
We will generally vote against any management proposal that is designed to limit shareholder democracy and has the effect of restricting the ability of shareholders to realize the value of their investment. Proposals in this category would include:

Golden Parachutes
These are special severance agreements that take effect after an executive is terminated following a merger or takeover. In evaluating such proposals, we will consider the salaries, bonuses, stock option plans and other forms of compensation already available to these executives to determine if the additional compensation in the golden parachutes is excessive. Shareholder proposals requesting that they be approved by shareholders will be supported.

Greenmail Payments
Greenmail is when a company agrees to buy back a corporate raider's shares at a premium in exchange for an agreement by the raider to cease takeover activity. Such payments can have a negative impact on shareholder value. Given that impact, we will want there to be a shareholder vote to approve such payments and we will insist that there be solid economic justification before ever granting such approval.

Super Majority Voting
Some companies want a super majority (e.g., 66%) vote for certain issues. We believe a simple majority is generally in the best interest of shareholders and we will normally vote that way unless there is strong evidence to the contrary.

Dual Class Voting
Some companies create two classes of stock with different voting rights and dividend preferences. We will examine the purpose that is being used to justify the two classes as well as to whom the preferred class of stock is being offered. Proposals that are designed to entrench company management or a small group of shareholders at the expense of the majority of shareholders will not be supported. Proposals that seek to enhance the voting rights of long-term shareholders will be given careful consideration.

Fair Price Proposals
These require a bidder in a takeover situation to pay a defined “fair price” for stock. Our analysis will focus on how fairly “fair price” is defined and what other anti-takeover measures are already in place at the company that might discourage potential bids that would be beneficial in the long term to shareholders.

Classified Boards
These are boards where the members are elected for staggered terms. The most common method is to elect one-third of the board each year for three-year terms. We believe the accountability afforded by the annual election of
the entire board is very beneficial to stockholders and it would take an extraordinary set of circumstance to develop for us to support classified boards.

**Shareholders’ Right To Call Special Meetings and Act By Written Consent**

These are important rights for shareholders and any attempts to limit or eliminate them should be resisted. Proposals to restore them should be supported.

**Shareholder Proposals**

Proposals submitted by shareholders for vote usually include issues of corporate governance and other non-routine matters. We will review each issue on a case-by-case basis in order to determine the position that best represents the financial interest of the plan beneficiaries. Shareholders matters include:

**Poison Pill Plans**

These plans are designed to discourage takeovers of a company, which can deny shareholders the opportunity to benefit from a change in ownership of the company. Shareholders have responded with proposals to vote on the plans or to redeem them. In reviewing such plans, we check whether the poison pill plans were initially approved by shareholders and what anti-takeover devices are already in place at the company.

**Independence of Boards and Auditors**

The wave of corporate/audit scandals at the start of the 21st Century provided compelling evidence that it is in the best interests of shareholders to support proposal seeking increased independence of boards (e.g., requiring supermajority of independents on boards, completely independent nominating, compensation and audit committees, stricter definitions of "independence", disclosures of conflicts of interest) and auditors (e.g., eliminate or limit “other” services auditors perform, rotation of audit firms). A related issue is the independence of analysts at investment banking firms. Proposals seeking to separate the investment banking business from the sell-side analyst research and IPO allocation process should be supported.

**Cumulative Voting**

This allows each shareholder to vote equal to the number of shares held multiplied by the number of directors to be elected to the board. Shareholders can then target all their votes for one of a few candidates or allocate them equally among all candidates. It is one of the few ways shareholders can attempt to elect board members. In studying cumulative voting proposals, we will review the company’s election procedures and what access shareholders have to the nominating and voting process.

**Confidential Voting**

Most voting of proxies in corporate America is not confidential. This opens the process to charges that management pressures shareholders or their investment managers to vote in accordance with management’s recommendations. We believe the concept of confidential voting is so fundamental to the democratic process and is so much in the best interest of shareholders that we would oppose it only in the most extraordinary circumstances.

**Shareholder Access To the Proxy For Director Nominations**

Proposals to provide shareholders access to the company proxy statement to advance non-management board candidates will generally be supported if they are reasonably designed to enhance the ability of substantial shareholders to nominate directors and are not being used to promote hostile takeovers.

**Separate Chairperson and Chief Executive Officer**

The primary purpose of the board of directors is to protect shareholder interests by providing independent oversight of management. If the Chair of the Board is also the Chief Executive Officer of the company, the quality of oversight is obviously hindered. Therefore, proposals seeking to require that an independent director serve as Chair of the Board will be supported. An alternative to this proposal would be the establishment of a lead independent director, who would preside at meetings of the board's independent directors and coordinate the activities of the independent directors.
Term Limit For Directors
Proposals seeking to limit the term for directors will normally not be supported because they can deny shareholders the service of well-qualified directors who have effectively represented shareholder interests.

Broader Participation On Boards
A more diverse board of qualified directors is in the best interests of shareholders. Therefore, proposal requesting companies to make efforts to seek more qualified women and minority group members will be supported.

Greater Transparency and Oversight
Shareholders benefit from full disclosure of board practices and procedures, company operating practices and policies, business strategy, and the way companies calculate executive compensation. Proposals seeking greater disclosure on these matters will generally be supported.

Executive/Director Compensation
Proposals seeking to tie executive and director compensation to specific performance standards, to impose reasonable limits on it or to require greater disclosure of it are in the best interests of shareholders. The expense of options should be included in financial statements (as required in Canada). Financial performance is the traditional measurement for executive compensation—the more specific the better. Where executive pay is based on metrics that are improved through share repurchases the impact of repurchases should be neutralized to avoid artificially inflating executive pay. Other performance measures can be a useful supplement to the traditional financial performance measurement and are worthy of consideration. Examples are regulatory compliance, international labor standards, high performance workplace standards and measures of employee satisfaction.

High Performance Workplaces
We will support proposals encouraging the high-performance workplace practices identified in the Department of Labor’s report that contribute to a company’s productivity and long-term financial performance.

Codes of Conduct
Proposals seeking reports on and/or implementation of such commonly accepted principles of conducts as the Ceres Principles (environment), MacBride Principles (Northern Ireland), Code of Conduct for South Africa, United Nations’ International Labor Organization’s Fundamental Conventions, fair lending practices and the U.S. Equal Employment Opportunity Commission are in the best interests of shareholders because they provide useful information and promote compliance with the principles.

Pension Choice
There has been a recent trend by companies to convert traditional defined benefit pension plans into cash-balance plans. This has proved controversial because cash-balance plans often hurt older workers and may be motivated by a company’s desire to inflate its book profits by boosting surpluses in its pension trust funds. Proposals giving employees a choice between maintaining their defined benefits or converting to a cash-balance will generally be supported.

Say on Pay
Shareholders in the United Kingdom, Australia, Norway, the Netherlands and Sweden have had an advisory vote on companies’ compensation reports for several years. Say on Pay proposals will be supported because they give shareholders meaningful input on a company’s approach to executive compensation without entangling them with the micromanagement of specific plans.

Majority Vote Standard for Director Elections
For years, most boards of directors were elected by a plurality vote standard—nominees who get the most votes win. In a non-contested election (which most are) the only vote options are “for” and “withhold authority.” That means a nominee could have only one share cast “for” him/her and still be elected, regardless of how many shareholders withheld their votes for that nominee. Therefore, proposals requesting that nominees in non-contested elections receive a majority of the votes cast will be supported.