FOR INFORMATION ONLY

April 23, 2020

TO: Trustees – Board of Investments

FROM: Jonathan Grabel
Chief Investment Officer

SUBJECT: **Investments Update – Corporate Governance**

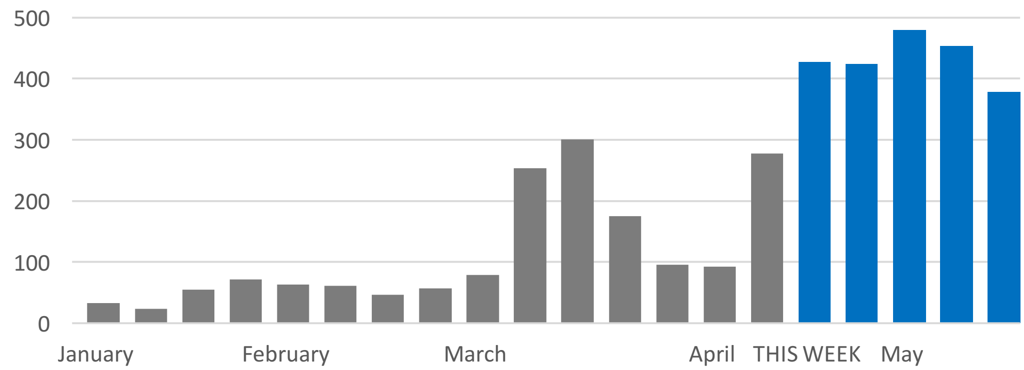
As part of our recent series of updates covering key activities in the wake of the COVID-19 pandemic, please find below information regarding LACERA's corporate governance initiatives.

LACERA's corporate governance strategies aim to encourage sound governance practices and policies at portfolio companies in order to protect and promote long-term financial value. These include a longstanding interest in issues that are front-and-center during the COVID-19 pandemic and related economic fallout, such as encouraging corporate boards to ensure sound corporate balance sheets in their capital allocation decisions and careful supply chain management, as well as recent growing attention to human capital management oversight (e.g. workplace health and safety measures). We discuss below current activities and how LACERA's *Corporate Governance Principles* (Principles) frame issues related to COVID-19 and the market downturn.

Proxy Voting

The COVID-19 pandemic unfolded on the eve of the annual proxy voting season – the period from April to June every year during which the vast majority of global companies hold their annual shareholder meetings and proxy voting occurs. Following account conversions during the past two years, LACERA has assumed legal rights to vote proxies at a much broader expanse of its global equity portfolio. LACERA's voting authority has grown from about 19% to 90% of the global equity portfolio by value, and from fewer than 2,000 meetings two years ago to about 8,000 anticipated for the current fiscal year ending June 30, 2020 – about a fourfold increase. Seventy-five percent (75%) of these meetings are occurring now and in upcoming weeks, with the table below demonstrating the sharp uptick in voting activity. The remainder of meetings occur throughout the rest of the year.

Number of Global Meetings to Vote Per Week
January to May 2020



LACERA's expanded voting authority allows us to execute votes consistently across our economic exposures in line with the fund's custom *Principles* policy, whereas previously delegating some voting rights to external managers meant that our economic exposures may be voted inconsistently. LACERA's *Principles* include numerous provisions striving to "raise the bar" in global governance, such as:

- ***Robust Board Independence***: We expect boards in all markets to have a supermajority of independent directors (at least 2/3rds) to promote objective oversight for investors.

- ***Board Diversity***: LACERA assertively encourages board diversity, universally scrutinizing board composition in all markets and voting against certain director nominees if the board lacks a track record of gender inclusivity.

- ***Core Investor Rights***: LACERA defends strong investor rights in part by opposing directors of recent initial public offerings (IPO's) that lack basic investor protections, such as weighted voting rights.

- ***Pay-for-Performance in Executive Pay***: LACERA is opposing executive pay plans where there is inadequate evidence that boards have properly linked pay to performance.

- ***Board oversight of material ESG risks***: We support reasonable proposals asking companies to assess and disclose how they are mitigating long-term business risks, such as cybersecurity, climate change, and supply chain monitoring.

Proxy Operations and Telecommuting Transition

Staff anticipated the heavy volume of voting and has smoothly transitioned to telecommuting with stable access to software and research tools facilitating electronic execution of our votes. We generally strive to cast votes about 7-14 days ahead of deadlines. For some non-U.S. meetings, we vote closer to vote deadlines due to shorter meeting notifications in some markets and availability of proxy-related research to analyze and inform votes consistent with LACERA's *Principles.*

The Rise of Virtual Meetings

A key impact of COVID-19 on the proxy voting season is that companies grappled early on with how to convene an annual meeting in compliance with securities law, while navigating rapidly developing restrictions on travel and in-person meetings, as well as stay-at-home orders. As of April 15, 2020, 1,427 companies globally have postponed annual meetings (including 83 in the U.S.). In markets where legally and logistically feasible, other companies have shifted their annual meetings to "virtual" meetings occurring via online technology. As of April 15, 2020, 1,660 companies have announced plans to hold virtual meetings, 1,015 of which are U.S. companies.

Virtual annual meetings have been an emerging trend. When combined with an in-person meeting, they provide some advantages, such as allowing investors to avoid the expense, time, and carbon footprint of travel and still participate in annual meetings. However, investors have also expressed caution due to possible abuses of virtual meetings. For example, a small number of companies that, prior to the pandemic, used such technologies were firms embroiled in controversies and anticipated facing difficult questions from investors. In light of the risk of abuses, LACERA policy – and that of the Council of Institutional Investors (CII) – encourage companies to consider technology to *broaden* investor participation, not limit it. The annual meeting is an opportunity for any investor to attend, listen, and ask questions to the board directors that we as investors elect.

In light of the pandemic, however, investors have accepted the use of virtual meetings this year as a means to convene the annual meeting and enable investors to exercise our rights to cast votes on important matters. We are closely monitoring the use of virtual meetings to ascertain effectiveness and possible abuses. As a practical matter, however, the expanded adoption of virtual meetings this year has not impeded LACERA's ability to execute proxy votes.

Proxy Results and Trends Review

As LACERA expands its proxy voting, we are monitoring trendlines and results. Once the fiscal year ends, we will compile year-end proxy voting statistics and highlight items for discussion with the Corporate Governance Committee, consistent with past practice (currently slated for October).

COVID-19 Market Implications From a Corporate Governance Lens

COVID-19 and the related market downturn have immediate and pressing ramifications for the policies and practices governing LACERA's portfolio companies. Our *Principles* address a wide range of implications – both immediate and over the long-term – some of which we discuss below (this is not an exhaustive list). LACERA is closely monitoring ramifications and the market downturn to ensure that our policies, proxy voting, and engagement work encourage corporate governance practices that are aligned with our institutional interests.

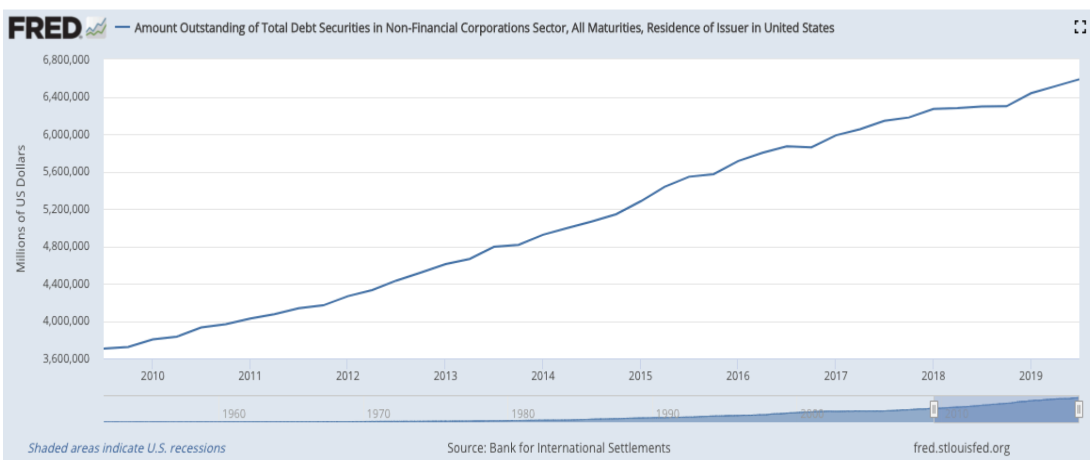
1. *Board of Directors and Oversight of Long-Term Risks for Sustainable Value Creation*

   Judicious oversight of long-term risks: LACERA's policy emphasizes the need for boards to think long-term and oversee how companies are identifying and mitigating risks that may impede sustainable cash flows and – more fundamentally – business continuity. These include matters highlighted in the midst of the COVID pandemic, such as concentrated risk in global supply chains impeding supplies and operations, as well as cybersecurity threats. Our *Principles* expect boards to oversee how corporate practices anticipate and mitigate these threats. We expect heightened market focus and disclosure on these issues in the wake of the pandemic.

Capital Allocation: A pivotal function of any board is oversight of capital allocation to ensure that a corporation's balance sheet is adequately sound. LACERA's *Principles* encourage a balanced and disciplined approach to capital allocation and encourage companies to explain how capital allocation decisions – inclusive of distributions (such as dividends and share buybacks) and reinvestments (research and development, corporate combinations, etc.) are conducive to generating sustainable returns.

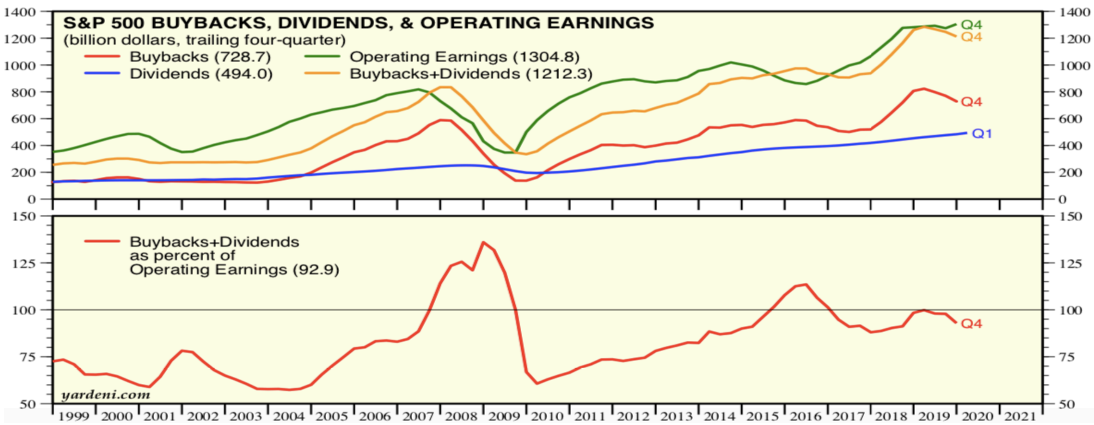
Corporate debt levels (fueled in part by a low interest rate environment) and share buybacks have significantly expanded through the bull market of the past decade. While many companies properly balance and explain capital allocation, the receding economic tide is revealing weaknesses in some corporate balance sheets. By the 4th quarter of 2019, for example, buybacks and dividends as a percentage of operating earnings stood at 92.9%.

Total Debt of Non-Financial Corporations
July 1, 2009 – July 1, 2019[1]



[1] Federal Reserve of St. Louis. Available at: https://fred.stlouisfed.org/series/TDSAMRIAONCUS.

S&P 500 Trendlines of Buybacks and Dividends by Value and as Percentage of Operating Earnings, 1999-2020[2]



We anticipate sharpened attention to how capital allocation decisions – inclusive of distributions to investors – position companies to endure the downturn and beyond, with better situated firms likely benefiting from lower costs of capital.

2. *Investor Rights*

LACERA advocates core investor rights to protect our interests and enable investors to act on matters that may fundamentally alter a corporation, such as mergers and acquisitions.

Poison Pills: In response to recent securities devaluations and volatility, there has been a recent spike in the number of public companies adopting "shareholder rights plans," or poison pills. Poison pills were invented in the 1980s-era of hostile takeovers. Institutional investors, including LACERA's *Principles*, caution that boards not use poison pills to entrench management or deter mergers that may otherwise be in investors' interests. We urge companies to enable investors to evaluate and vote on poison pill plans as soon as practicable and assess them on a case-by-case basis, generally expecting poison pills adopted amidst market downturns to be limited in duration and carefully justified.

3. *Aligned Interests in Executive Compensation Design and Incentives*

LACERA's *Principles* expect pay programs for executives to align their interests with ours as investors. We are carefully watching compensation committee decisions in the wake of the downturn for strategies that may inflate executive pay despite corporate performance:

- Options re-pricing
- "Moving the goal posts" or modifying previously stated incentive pay metrics
- One-off retention awards and "special bonuses"

[2] Yardeni Research. *Corporate Finance Briefing: S&P 500 Buybacks and Dividends.* April 22, 2020. Available at: https://www.yardeni.com/pub/buybackdiv.pdf.

Such provisions undermine the philosophy of "at-risk" executive pay and are instead a "heads we win, tails you lose" proposition for investors. LACERA's *Principles* generally oppose these practices. When a company adopts these or related maneuvers, we expect adequate justification, absent which we vote against pay proposals and, if necessary, the directors who are accountable for making these decisions.

4. *Transparency in Performance Reporting*

LACERA *Principles* expect clear, timely, and accurate reporting of information adequate for investors to form an informed view of a company's financial position and prospects. The recent bull market saw a parallel growth in innovations and techniques to financially manage supply chains, such as "supplier finance." Such arrangements afford flexibility in how supply-related liabilities are accounted, but possibly at the risk of obscuring an adequate understanding of a firm's debt. The downturn may test the clarity of financial liability accounting and prompt greater scrutiny of audit committees and auditors.[3]

5. *Prudent Mitigation of Social, Environmental, and Other Key Operating Risks*

Human capital management: The pandemic has fueled further investor interest in understanding risks and opportunities related to how companies manage and secure the safety of their workforces. We are observing broad attention to how firms navigate employee retention, as well as scrutiny of practices such as paid sick leave and availing personal protective equipment, that may mitigate the risk of community spread at a workplace, legal liabilities, and damage to brand equity/reputation.

Climate: The COVID-induced downturn has prompted significant turmoil in energy markets, including this week's negative West Texas Intermediate (WTI) crude oil futures pricing. Energy prices below operating costs may prompt companies to reduce supply, absent government intervention. Fluctuations in the energy markets highlight the need for energy firms' capital expenditures today to prudently anticipate both sudden and gradual shifts in consumer demand, technological innovations, and regulations – including those related to climate change – that may reshape the industry into the future.

The team continues careful diligence of emerging corporate governance implications of the pandemic and economic downturn to exercise the fund's legal rights consistent with LACERA's established policies. We will be reporting to the Board and Corporate Governance Committee on these efforts, among our other engagement and ESG integration work, at upcoming meetings.

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[3] See Deloitte, LLP. *Clarity in financial reporting: Implications of supplier finance arrangements on trade payables.* July 2018. Available at: https://www2.deloitte.com/content/dam/Deloitte/au/Documents/audit/deloitte-au-audit-implications-supplier-finance-arrangements-trade-payables-2018-120718.pdf; Bridget McCrea. "7 Supply Chain Financing Trends to Watch in 2019." Supply Chain Management Review. March 6, 2019. Available at: https://www.scmr.com/article/7_supply_chain_financing_trends_to_watch_in_2019.