I am proud to present the people of Illinois with our first annual update on our sustainable investment activities, which are crucial in advancing our goals to maximize returns and safeguard long-term assets.

In 2017, the Treasurer's Office engaged companies on a broad range of sustainability issues, including environmental, social, and governance (ESG) risks and opportunities, through direct outreach and proxy voting. We joined with investor coalitions to strengthen our impact and share resources for this important work.

This report highlights key initiatives summarized below:

• **Closing the Gender and Racial Divide: Board Diversity**—The Illinois Treasury joined seven Midwest institutional investors to urge local companies to shake up their uniformly white male boards of directors by adding women and minorities. Nine firms adopted policies to create a pipeline for diverse candidates and six appointed female directors.

• **Human Capital Management**—The Illinois Treasury submitted an argument to the Securities and Exchange Commission urging that companies be required to disclose data on human capital metrics. Most companies in our service-based economy cite their employee base as their most valuable asset, but investors have virtually no data on a company's workforce composition, stability, or health and safety.

• **Pay Parity**—The Illinois Treasury voted for Alphabet, American Express, Bank of America, Citigroup, CVS Health, Express Scripts, Facebook, JPMorgan Chase, Mastercard and Wells Fargo to report and reduce the gender pay gap in their workforce.

• **Board Accountability**—The Illinois Treasury used the power of the proxy to support a more accountable board of directors. The Treasury supported 16 proposals to appoint an independent chairman, five proposals to require directors receive a majority of support from shares outstanding to be seated on the board, and two proposals to require each director stand for election on an annual basis.

• **Opioid Epidemic: Issues in the Supply Chain**—The opioid epidemic is a complex problem and its remedy requires action by all actors in the supply chain, including firms that manufacture and distribute opioids. The Illinois Treasury is engaging companies to discuss steps to help fight the epidemic and reduce their exposure to financial, legal, and reputational risks.

• **Sustainability Fully Integrated across the Treasurer's Office Investment Programs**—The Treasurer's Office formalized additional policies and processes to better integrate sustainability factors in the review of debt issuers, fund managers, equity holdings, and all due diligence activities.

• **Restoring Integrity to Public Information: Cracking Down on Fake News at Facebook and Alphabet**—The Illinois Treasury pressed the social media companies to report on the epidemic of fake news and their progress towards a solution.

• **Addressing Environmental Risks and Opportunities**—The Illinois Treasury filed a shareholder proposal at Kaiser Aluminum to request the company issue a sustainability report. Following negotiations with the office, the company launched a website on sustainability and agreed to follow with a comprehensive report.

• **Purchased $70 million in Green and Social Impact Bonds**—The Illinois Treasury purchased $70 million in green and social impact bonds, which provide an excellent return on investment while supporting important projects that aim to create a more sustainable, prosperous future.

For those keeping count, the Illinois Treasury voted on 4,060 proposals on corporate proxy ballots and engaged hundreds of companies on sustainability issues since it launched Raising The Bar in September 2016.

**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, sustainability, and the common good. By doing so, not only do we position ourselves to protect shareholder value and maximize 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](http://www.IllinoisRaisingTheBar.com).

Onward,

Illinois State Treasurer
RAISING THE BAR—OUR VIEW ON SUSTAINABILITY

Making Responsible Choices. Investing means making choices. For the decision-makers at the Illinois State Treasurer’s Office, it means choosing investments that are low risk, high-performing, and sustainable. It means making investments that not only strengthen the economic well-being of Illinois citizens and institutions, but making investments that reflect our commitment to inclusion, sustainability, and sound corporate governance.

Sustainability Factors. We at the Treasurer’s Office know that to fulfill our fiduciary duty and maximize returns, we need to focus on more than just short-term gains and traditional indicators. Additional risk and value-added factors that may have a material and relevant financial impact on the safety and performance of our investments need to be integrated into the decision-making process. These material sustainability factors include (1) environmental; (2) social capital; (3) human capital; (4) business model and innovation; and (5) leadership and governance factors.

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

ESG INTEGRATION: WHY IT MATTERS

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

Traditional Investing
- Conventional Risk Factors
- Short Term Gains


Raising the Bar: Treasurer Frerichs’ 2017 Annual Sustainability Report

The investment policies that govern the Treasurer’s investment programs all specify that sustainability factors shall be integrated as components of portfolio construction, investment decision-making, investment analysis and due diligence, and risk management, given that these tangible and intangible factors may have a material and substantive financial impacts as well as non-financial impacts.

Corporate Engagements—The Treasurer’s Office directly engages portfolio companies through shareholder proposals, advocacy letters, and/or direct dialogue to address sustainability risks and opportunities.

Proxy Voting—The Treasurer’s Office exercises its proxy voting rights to address sustainability risks and opportunities at portfolio companies.

Fund Manager Selection—The Treasurer’s Office and its contractors evaluate fund managers by their Morningstar ESG rating and sustainability track record to optimize portfolios for long-term returns.

Investment Analysis and Due Diligence—The Treasurer’s Office conducts regular analysis and due diligence of fund managers to identify and address sustainability risks and opportunities.

Risk Management—The Treasurer’s Office incorporates sustainability factors and third-party ratings into the review of debt issuers, utilizing sources such as the Sustainability Accounting Standards Board, Sustainalytics, and Community Reinvestment Act evaluations, to identify material financial risks and opportunities.

Advocacy and Policymaking—The Treasurer’s Office actively engages lawmakers and government entities to ensure the regulatory framework is well-structured to protect institutional investors and promote sustainable investing.

Active Ownership Creates Value. When company leaders effectively measure and manage material sustainability issues, companies are better positioned to deliver long-term value to investors. As such, the Treasurer’s Office directly engages corporate boards and company leaders to encourage regular evaluation of sustainability factors and long-term financial, legal, regulatory and reputational risks. This further the goal of the Treasurer’s Office to increase expected financial returns, minimize projected risk, and contribute to a more just, accountable, and sustainable global economic marketplace.
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 Office’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 LGBTQ.

• **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.
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 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.
Environmental Factors

Environmental stewardship is a shared responsibility. Furthermore, 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 Office 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.

A company’s awareness of environmental risks and opportunities may have a significant impact on its operational capacity, financial position, and long-term sustainability.
TREASURER’S OFFICE SHAREHOLDER ADVOCACY EFFORTS

Opioid Epidemic: Issues in the Supply Chain

THE PROBLEM
The Centers for Disease Control and Prevention reports that 91 Americans die every day from an opioid overdose. One study put the economic burden of opioid abuse resulting in increased health care, substance abuse treatment, criminal justice and other costs at $78.5 billion in a single year. In October, President Trump declared the opioid epidemic a national public health emergency.

One of the many facets of why the United States is in the midst of an opioid epidemic deals with the supply chain of opioid manufacturing and distribution. The five major opioid manufacturers are facing subpoenas from a coalition of 41 states attorney generals on their marketing and sales tactics. The investigation questions whether the companies minimized the risks of addiction and overdose for opioids even when they are used as directed. Similar lawsuits are mounting from more than 60 cities, counties and states throughout the country.

TAKING ACTION
The Treasurer's Office is involved with two initiatives to engage companies in the opioid supply chain. The Treasurer’s Office formed a coalition with state treasurers from California, Rhode Island, Pennsylvania and West Virginia focused on engaging companies in the opioid distribution industry. The Treasurers’ Coalition cooperates on shareholder advocacy efforts and speaks collectively on behalf of the shared assets of the five states. Additionally, the Treasurer's Office is one of 30 institutional investor members of the Investors for Opioid Accountability (“IOA”). The IOA is a coalition of 44 treasurers, asset managers, faith-based, public and labor funds with over $2.2 trillion in assets.

In the case of the distributors, McKesson, Cardinal Health and AmerisourceBergen failed to flag suspicious shipments to pharmacies. In one case, drug distributors shipped 780 million hydrocodone and oxycodone prescription opioids to West Virginia in a six-year period, enough for about 433 pills for every man, woman and child in the state. During that time, 1,728 people fatally overdosed from those two opioids. McKesson, Cardinal Health and AmerisourceBergen together supplied more than half of the total, according to reports in the Charleston Gazette-Mail.

The Treasurers’ Coalition has requested a series of corporate governance improvements at the three distributors that coincide with the proposals of the IOA. Improved corporate governance will ensure the board of directors is better structured to hold management accountable for its handling of the crisis. The IOA collectively filed a series of shareholder proposals at 10 companies in the opioid supply chain: Alkermes; AmerisourceBergen; Cardinal Health; Depomed; Endo; Insys; Johnson & Johnson; Mallinckrodt; McKesson and Pfizer. The proposals ask the companies to adopt a series of disclosures and reforms including to:

1. Appoint an independent director to chair the board;
2. Form a committee of independent directors to issue a report on opioid business risks;
3. Adopt a claw-back provision for executive pay in the case of misconduct;
4. End the practice of excluding legal costs when assessing progress on metrics for executive incentive compensation;
5. Publicly disclose political spending; and

**PROGRESS TO DATE**

McKesson, Cardinal Health and Endo reacted positively to the proposals. McKesson agreed to (1) launch an investigation, led by independent board members, of its opioid-related business practices; (2) separate the roles of CEO and board chairman when the current CEO retires; and (3) review its pay practices after 73% of investors rejected its pay package in 2017 as excessive in light of the problems the company faced due to opioid distribution practices.

Treasurer Michael Frerichs attended the Cardinal Health stockholder’s meeting in October, shortly prior to which the CEO announced he was stepping down. Cardinal Health also: (1) separated the roles of board chairman and CEO and (2) announced an Opioid Action Program comprised of steps to help fight the crisis including distributing free doses of the overdose-reversing drug Narcan; supporting drug recoupment efforts; and investing in prevention and education programs.

Endo agreed to (1) issue an independent director report on opioid business risks; (2) adopt a claw-back provision for executive pay in the case of misconduct and (3) publicly report political spending.

While these are positive steps, much more is needed. Each entity in the opioid supply chain should look hard for opportunities to course correct after failing to stem the crisis. The investors’ initiatives are ongoing.
Board Diversity

THE PROBLEM
Companies that lack diversity put themselves at a competitive disadvantage. Successful boards make for successful companies, and the research indicates boards that embrace the strategic value of diversity are better structured for success. A wealth of research shows that diversity benefits corporate decision-making and company performance. Companies with diverse boards are more likely to have strong financial performance, and fewer instances of bribery, corruption, shareholder battles, and fraud. Diversity is inclusive of skill sets, professional backgrounds, gender, race/ethnicity, and LGBT status. Executives, scholars, and major investment firms like State Street and Vanguard strongly endorse the link between diversity and board effectiveness and the creation of long-term shareholder value.

TAKING ACTION
The Treasurer’s Office is talking directly to corporate leaders and lending its financial weight to a wider investor movement to increase racial and gender diversity among corporate boards.

The Treasurer’s Office is a participant in two complementary coalitions working on board diversity. The Thirty Percent Coalition, which is comprised of 90 members including institutional investors with $3.2 trillion in assets under management, works with companies in a variety of ways to promote board diversity. Formed in June 2017, the Midwest Investors Diversity Initiative, comprised of regional institutional investors and led by the UAW Medical Benefits Trust, engages with local companies and requests they adopt the Rooney Rule.

Adopted from the NFL, the Rooney Rule states the companies will include diverse nominees in the candidate pool for an open board seat. The NFL established the Rooney Rule in 2003 to require minorities be included in every recruitment pool for head coach searches. The more diverse candidates in the pipeline, the better the odds of selection. Three years after the Rooney Rule was adopted by the NFL, the percentage of African-American coaches jumped from six percent to 22 percent.

Recent studies on the business case for diversity:

- LeanIn.Org and McKinsey & Company released a study in October on gender equality in the workplace. The study, Women in the Workplace 2017, examined 222 companies and found company commitment to gender diversity is at an all-time high for the third year in a row.

- A February 2016 report by the Peterson Institute for International Economics found “Firms with More Women in the C-Suite Are More Profitable.”

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

- 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.
Midwest Diversity Initiative

A collaboration of institutional investors regionally positioned to engage local companies on adopting the Rooney Rule. Led by the UAW Medical Benefits Trust, the group includes Segal Marco, the Office of the Treasurer for The State of Illinois, Ohio Public Employees Retirement System, School Employees Retirement System of Ohio, SEIU Master Trust, State of Wisconsin Investment Board, Sundance Family Foundation, Trinity Health, and WesPath Investment Services.

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<th>Corporate Engagement on the Rooney Rule for Board Diversity</th>
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<td><strong>Shareholder Proponents</strong></td>
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These tactics are long-term in nature given the slow pace of board refreshment. The average tenure for a director is six to 10 years and an enforced mandatory retirement age is rare in corporate America. Still, the Wall Street Journal reported in November that Spencer Stuart, an executive recruitment firm, found that the number of women and minority directors on boards hit a record high in 2017. S&P 500 firms placed 397 independent directors and half of them were diverse. Forty-two percent of first-time directors are women, up from 32 percent in 2016.

In addition to corporate engagement, the Treasurer's Office will begin voting against nominating committee members at U.S. firms where the board has no female directors in March 2018. The Treasurer's Office is in good company with its shift in proxy voting. State Street Global Advisors ("SSGA") erected the defiant girl statue squaring off against the Wall Street bull statue to celebrate an announcement that it would vote against the election of the chair on nominating and/or governance committees should firms fail to increase the number of women on their board. The other two major passive investment managers, Blackrock and Vanguard, announced similar initiatives along with SRI funds and several public pension funds. The Pension Reserves Investment Management (PRIM) Board, which oversees Massachusetts’ $62 billion pension fund announced in February that it will vote against all board nominees if less than 30 percent of the company’s board is diverse in terms of gender and race.
Income Inequality: Tamping Down on Executive Compensation

THE PROBLEM

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.”

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. EPI pointed to the stark rise in the ratio from 1965, when the ratio was 20:1, which is 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.

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, “[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.” (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.

TAKING ACTION

The Treasurer’s Office joined a group of 11 other institutional investors wrote to 318 Russell 3000 firms that do not have annual say-on-pay votes to ask that they move in that direction. In 2017, companies that opted for a triennial say-on-pay vote went 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. Shareholders at 146 of the firms elected an annual vote on executive compensation at the 2017 stockholder’s meeting.
Restoring Integrity to Public Information: Cracking Down on Fake News

THE PROBLEM

Fake news poses financial risks to investors.
The distribution of fake news by companies like Facebook and Google is a major area of concern. These corporations are facing a multitude of financial, regulatory, legal, and reputational risks as more and more reports come out documenting the breadth of fake accounts, news manipulation, hate speech, and election interference on these digital platforms.

Facebook Chairman Mark Zuckerberg addressed this point directly in February when he wrote in an open letter: “In the last year, the complexity of the issues we’ve seen has outstripped our existing processes for governing the community.”

Companies that run social media platforms historically viewed themselves as agnostic about the content shared on their sites but that perspective seems posed to change. The New York Times reported in a December 13, 2017, article, “Because this year, for the first time, tech giants began to grudgingly accept that they have some responsibility to the offline world. The scope of that responsibility, though, is another matter entirely.”

Fake news poses a threat to democracy and the public interest. As an elected representative and public official, the Treasurer’s Office is concerned that fake news and media manipulation may have detrimental impacts on our democratic processes. We need a properly informed electorate that is not systematically deceived and manipulated.

We need more corporate accountability and transparency on these issues. Companies need to (1) accept their responsibility in this matter, (2) engage stakeholders in an open discussion on solutions, and (3) review the impact of fake news on management systems and operations.

TAKING ACTION

In 2017, State Treasurer Michael Frerichs joined with equity manager Arjuna Capital to press Facebook and Google on global content governance. Treasurer Frerichs and Arjuna Capital took the position that companies need to step up their role as gatekeepers of the content shares on their sites. The Treasury’s shareholder proposal to Facebook characterized the social media firm as an information fiduciary with an obligation to responsibly manage content. With more than 2 billion users, Facebook sits at the center of global controversies extending from its role in Russia’s election interference during the 2016 U.S. presidential election to the dissemination of violence and hate speech.

Facebook at times appears unable to exert control over the platform it created. Mark Zuckerberg, in a February 2017 letter, said, “In the last year, the complexity of the issues we’ve seen has outstripped our existing processes for governing the community.” While Facebook retooled algorithms early in 2018 and hired staff to vet fake news, the company has yet to report to shareholders on how it intends to oversee the multiple risks to its business outlook posed by its Frankenstein predicament.
Human Capital Management

WHY IT MATTERS

Effective human capital management strategies are a driver of positive long-term performance, enhanced worker productivity and better risk mitigation. This translates into higher total shareholder return, return on assets, and return on capital, profitability, and overall firm performance against benchmarks.

There is a large body of empirical work that support the link between effective human capital management and corporate performance include the following.¹,²,³,⁴,⁵,⁶,⁷,⁸,⁹

TAKING ACTION

A petition to the SEC was filed in June by the Human Capital Management Coalition ("HCM Coalition"), a global group of 25 institutional investors representing over $2.8 trillion in assets. The rulemaking petition asks the Commission to require listed companies report on human capital management policies, practices, and performance. The SEC currently only requires that companies report employee headcount. The petition asks for more comprehensive corporate reporting in nine areas: Demographics; Workforce stability; Workforce composition; Workforce skills and capabilities; Workforce culture and empowerment; Workforce health and safety; Workforce productivity; Human rights commitments and their implementation.

The HCM Coalition’s view is that talent management is material to company performance and long-term profitability and without systematic reporting investors are unable to vet companies on these measures. The State Treasurer’s Office is an active participant in the HCM coalition and submitted a brief in support of the rulemaking.


Tackling Environmental Risks and Opportunities

WHY IT MATTERS

As investors and analysts know that corporations with poor or short-sighted sustainability policies are more exposed to material environmental risks, including fines, supply chain issues, higher operating costs, and reputational issues. These risks may have adverse impacts on financial performance and investment returns, especially in the long-term. As such, the Treasurer’s Office has developed a direct financial interest in ensuring that its portfolio companies are carefully managing and measuring environmental risks and opportunities in areas such as, but not limited to:

• Carbon emissions;
• Air quality;
• Energy management;
• Water and wastewater management;
• Waste and hazardous materials management; and
• Biodiversity impacts.

TAKING ACTION

The Treasury undertook several initiatives in 2017 aimed at keeping our air clean and our climate stable. The Office joined with the treasurers and comptrollers of nine other states to urge the Environmental Protection Agency to avoid a rule making that would weaken efforts to reduce carbon dioxide emissions. Through its corporate governance program, the Treasury exchanged letters with Exxon Mobil on its oversight and reporting functions of climate change risks as they pertain to its capital planning and business strategy. Finally, the Treasury invested $55 million in green bonds, which fund investments in renewable energy, sustainable forestry, energy efficiency, and the production of clean energy sources.
PROGRESS IN ACTION

Strategic Partnerships

The Treasurer's Office gains immense value working in partnership with coalitions, corporate governance experts, and other investors. Partnerships help us pursue learning opportunities, advance leading investment practices, and ultimately be better fiduciaries seeking to protect assets and maximize returns.

That’s why we are active members of several major investor networks, including those featured below, which are made up of leading asset management firms, public pension funds, labor funds, foundations, endowments, family offices, and other state treasurers.

Green and Social Impact Bonds

The State Treasurer’s Office invested $70 million to promote the advancement of green technologies, renewable energy, and projects that provide essential services to underserved populations.

The green bonds fund investments in renewable energy, sustainable forestry, energy efficiency, and the production of clean energy sources.

The social impact bonds fund investments in companies that source directly from smallholder farmers; provide utilities that provide for low-income households; offer affordable health services, education, or housing to low-income people, lending to financial intermediaries with the requirement that the proceeds be on-lent to women-owned enterprises.

Green and social impact bonds provide an excellent return on investment and support important projects that aim to create a more sustainable, prosperous future.

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<td>$15,000,000</td>
<td>1.650%</td>
<td>09/28/2022</td>
<td>09/28/2017</td>
</tr>
<tr>
<td>IFC Green Bond</td>
<td>$15,000,000</td>
<td>2.084%</td>
<td>10/24/2022</td>
<td>10/24/2017</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$70,000,000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
OPPORTUNISTIC STRATEGIES
WITH MWVD FIRMS

Treasurer Frerichs believes that our government should mirror the diversity in our state. And furthermore, diversity is good for business. In the last year, the Treasurer’s Office has made great strides to ensure inclusion and provide more opportunities for Minority, Women, Veteran, and Disabled (MWVD) firms. Among Treasurer Frerichs’ top priorities is to continue to transform the Office’s culture, policies, and operations to help ensure equal opportunity.

Increasing Business with MWVD Broker/Dealers: From 1% to 63%.

The Treasurer’s Office two internally managed investment programs, the State Investment Portfolio and Illinois Public Treasurers’ Office Investment Pool (also referred to as “The Illinois Funds”), are made up of direct purchases and brokered investments. Tapping diverse-owned broker/dealers is one of the quickest and best ways to ensure MWVD participation—and recent numbers emphasize our sustained progress in this area:

Since 2015, the Treasurer’s Office increased utilization of diverse broker/dealers from 1% to 63%.

<table>
<thead>
<tr>
<th>Year-by-Year Comparison of Assets Brokered with MWVD Firms</th>
<th>FY 2012—FY 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Investments + Illinois Funds</td>
<td>FY12</td>
</tr>
<tr>
<td>Assets Brokered by MWVD Firms</td>
<td>$925 million</td>
</tr>
<tr>
<td>Total Assets Available to MWVD Firms</td>
<td>$21 billion</td>
</tr>
<tr>
<td>% Brokered by MWVD Firms</td>
<td>4.4%</td>
</tr>
</tbody>
</table>

Increasing Business with MWVD Asset Managers: From $16 million to $295 million.

The Treasurer’s Office utilizes assets managers to support various investment programs, including, but not limited to, the 529 College Savings Program, the State Investment Portfolio, The Illinois Funds, and the Illinois Growth and Innovation Fund.

The Treasurer’s Office has made tremendous strides expanding the use of MWVD asset managers. Utilization of diverse asset managers increased from $18 million in January 2015 to $295 million as of December 2017. That represents an 18-fold increase.

TREASURER’S OFFICE—ASSETS BROKERED BY MWVD FIRMS
FY 2013 – FY 2017
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 Michael Frerichs wrote to the Illinois Delegation in advance of the vote to urge their opposition.

Treasurer Frerichs joined with 13 other state treasurers across the country to defend shareowner rights in a joint statement to Congress. The letter defended the current regulatory framework that provides investors with the 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 the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The pay ratio disclose rule required U.S. listed companies to report on the ratio of their CEO compared to that of the median worker. The provision has remained intact and companies will report their pay ratio in their 2018 proxy statements. The Illinois Treasury amended its proxy voting policy to include the ratio as criteria when voting on executive pay plans.
PROXY VOTING
The Treasurer’s Office votes its proxies in line with the Proxy Policy Statement available on page X of this report. In 2017, the Treasurer’s Office voted 4,060 proposals at 337 companies. A full list of the votes cast is available on the Treasurer’s Raising The Bar website.

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.

<table>
<thead>
<tr>
<th>Company</th>
<th>Issue</th>
<th>AFL-CIO Recommendation</th>
<th>STO Vote</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aetna Inc.</td>
<td>Report on Gender Pay Equity</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Amazon.com, Inc.</td>
<td>Report on Use of Criminal Background Checks</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Bank of America Corporation</td>
<td>Report on Gender Pay Equity</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Bed, Bath &amp; Beyond Inc.</td>
<td>Shareholder Approval of Golden Parachutes</td>
<td>For</td>
<td>Proposal not on agenda</td>
</tr>
<tr>
<td>Caterpillar Inc.</td>
<td>Amend Clawback Policy</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>The Charles Schwab Corp.</td>
<td>Proxy Access</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Community Health Systems, Inc.</td>
<td>Limit Accelerated Vesting</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Eli Lilly and Company</td>
<td>Lobbying Disclosure</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>Amend Bylaws by Majority Vote</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Express Scripts Holding Company</td>
<td>Independent Chair</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Exxon Mobil Corp.</td>
<td>Lobbying Disclosure</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>FleetCor Technologies, Inc.</td>
<td>Board Diversity</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Gaming &amp; Leisure Properties, Inc.</td>
<td>Majority Vote Director Elections</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Home Depot, Inc.</td>
<td>Report on Employee Diversity</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Hospitality Properties Trust</td>
<td>Opt Out of Maryland’s Unsolicited Takeover Act</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>International Business Machines Corporation</td>
<td>Proxy Access</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>Independent Chair</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co.</td>
<td>Government Service Golden Parachutes</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Mondelez International, Inc.</td>
<td>Report on Impact of Plant Closures</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Netflix, Inc.</td>
<td>Majority Vote Director Elections</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Newmont Mining Corporation</td>
<td>Human Rights Risk Assessment Process</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>PayPal Holdings, Inc.</td>
<td>Report on Sustainability</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<td>Reynolds American Inc.</td>
<td>Human Rights Mediation</td>
<td>For</td>
<td>No annual meeting a/o 06-22-17</td>
</tr>
<tr>
<td>SL Green Realty Corp.</td>
<td>Target Amount Setting for CEO Compensation</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Skechers U.S.A., Inc.</td>
<td>Board Diversity</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>Tesla, Inc.</td>
<td>Declassify Board</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>The Travelers Companies, Inc.</td>
<td>Report on Employment Diversity</td>
<td>For</td>
<td>No Share Position</td>
</tr>
<tr>
<td>T-Mobile US, Inc.</td>
<td>Proxy Access</td>
<td>For</td>
<td>For</td>
</tr>
<tr>
<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>
</tbody>
</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 Office voting is 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 averse 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.
RATIFICATION OF AUDITORS

A vote to approve auditors is the second most commonly voted managed proposal and a pillar of good corporate governance. 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

The Dodd-Frank legislation provided 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.

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**303**

the number of proposals the Treasurer’s Office voted on to ratify auditors of companies in 2017

**63%**

the percentage of those 303 proposals that the Treasurer’s Office supported

**298**

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

**53%**

the percentage of those 298 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. Hunt, Vivian. “Why Diversity Matters.” McKinsey & Company. January 2015. https://www.mckinsey.com/business-functions/organization/our-insights/why-diversity-matters.

21

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

100%

the percentage of those 21 proposals that the Treasurer’s Office supported
CONCLUSION

The Treasurer’s Office seeks to invest all funds under its control in a manner that provides the highest risk-adjusted investment return for beneficiaries using authorized instruments. To achieve this objective, the Treasurer’s Office has a responsibility to recognize and evaluate risk factors that may have a material and relevant financial impact on the safety and/or performance of our investments.

As such, the Treasurer’s Office prudently integrates sustainability factors into its investment processes in order to help fulfill core fiduciary duties, which include maximizing anticipated financial returns, minimizing projected risk, and in a larger sense, contributing to a more just, accountable, and sustainable State of Illinois.

For regular updates and more information on the sustainable investing activities of the Treasurer’s Office, please visit www.IllinoisRaisingTheBar.com.