

## SUMMARY

AB 1967 specifies criteria pertaining to human rights that countries affiliated with Sovereign Wealth Funds (SWFs) must meet in order for CalSTRS and CalPERS to make new investments in or with private equity companies (also known as general partnerships) that are (1) owned in whole or in part by these SWFs and (2) not listed on a public exchange.

## PURPOSE OF THE BILL

There is a perception that CalSTRS and CalPERS have sufficient clout in the private equity market such that threatening to prohibit future investments in certain companies would influence minority stake holders in those companies to pressure their countries to make certain public policy decisions. AB 1967 attempts to leverage this perceived influence to affect human rights policies in foreign countries.

## BOARD POSITION

**Oppose.** This bill restricts the investment authority of the Teachers' Retirement Board, the result of which is a loss of between \$1.5 billion and \$5.3 billion over five years, in addition to increased administrative costs for compliance and potential increased legal costs.

## SUMMARY OF AMENDMENTS

N/A

## LEGISLATIVE HISTORY

Chapter 671, Statutes of 2007 (AB 221—Anderson) prohibited CalSTRS and CalPERS from investing in companies with business operations in Iran and required each pension system to sell or transfer any investments in a company with business operations in Iran. When the U.S. repeals its sanctions against Iran, the pension Boards this bill requires the pension boards to notify the Secretary of State, and the prohibitions and requirements in this bill will be repealed.

Chapter 441, Statutes of 2006 (AB 2179—Leslie) indemnified from the state General Fund all current or former regents, officers, employees, and contractors of the University of California (UC) from all liability for any decision of the UC Regents not to invest in any company involved in significant business activities that provide revenue to the Sudanese government.

Chapter 442, Statutes of 2006 (AB 2941—Koretz) required CalSTRS and CalPERS to divest from companies having business operations in the Sudan, according to specified criteria.

Resolution Chapter 98, Statutes of 2005 (ACR 11—Dymally) requested that CalSTRS and CalPERS encourage in the funds those companies that are doing business in Sudan to refrain from actions that promote or otherwise enable human rights violations in the Sudan.

AB 2745—Kaloogian (2000) would have encouraged CalSTRS and CalPERS not to invest in foreign companies that pose a threat to national security and to annually report to the Legislature regarding such investments, as specified. Held in Assembly Appropriations Committee.

SB 1928—Haynes (2000) would have encouraged the CalSTRS and CalPERS not to invest in foreign companies that pose specified threats. Held in the Assembly Appropriations Committee.

Chapter 341 Statutes of 1999 (SB 105—Burton) mandated that CalSTRS report investments in companies operating in Northern Ireland and that it encourage affirmative action there, as specified. The bill did not require divestment, but allowed engagement.

Chapter 30, Statutes of 1994 (SB 1285—Watson) repealed AB 134, the 1986 South African divestment bill, and granted indemnification of the Board. The Board supported this bill because it was consistent with the Board's fiduciary duty and expanded its investment opportunities.

Chapter 1254, Statutes of 1986 (AB 134—M. Waters) required state pension systems to divest state trust moneys annually by one-third the value of their investments in firms with business operations in South Africa or business arrangements with the government of South Africa and in financial institutions making or increasing loans or extensions of credit to the government of South Africa or a South African corporation. The bill specified exemptions and granted Board indemnification.

## PROGRAM BACKGROUND

### Sovereign Wealth Funds

'Sovereign Wealth Fund' is a term that generally describes a government's investment fund, though the definition is not technical and may encompass several forms. The U.S. Congressional Joint Economic Committee defines a SWF as one of the four main ways in which governments invest:

- *International reserves* are a country's liquid, low-risk assets generally held as U.S. Treasuries or highly rated government debt;
- *Pension funds* are government funds that invest with the goal of paying promised future benefits, and because these benefits are in domestic currency, these investments are generally domestic;
- *State-owned enterprises* are domestic companies that the government controls through significant stock ownership; and
- *SWFs* are monetary funds through which the government seeks higher returns by investing in a wide variety of assets, most of which are foreign assets.

These distinctions are not strict, however. Some central banks such as the Saudi Arabia Monetary Authority make diverse, long-term investments similar to SWFs.

SWFs have a variety of management styles: the Abu Dhabi Investment Authority (ADIA), for example, is actively managed by members of the Abu Dhabi royal family (one of several royal families in the United Arab Emirates (U.A.E.)); the Stabilization Fund of the Russian Federation is managed by Russia's Ministry of Finance; and the Kuwait Investment Authority outsources management to professional fund managers. In terms of market power, SWFs constitute significant sources of investment capital. The U.S. Congressional Joint Economic Committee lists 39 SWFs (see Appendix A) with over US\$1 billion in assets as of fall 2007. All together, these 39 SWFs hold \$3.2 trillion in assets. The largest SWFs are maintained by countries with significant oil revenue, such as the U.A.E., Norway, Saudi Arabia, and Kuwait, as well as countries with significant excess foreign reserves, such as Singapore and China. Three of the SWFs with over \$1 billion in assets are U.S.-based: the Alaska Permanent Fund, the New Mexico State Investment Office Trust Funds, and the Permanent Wyoming Mineral Trust Fund.

SWFs have been more prominently in the news since 2007, when state-owned Dubai Ports World sought to purchase several U.S. port operations. There has been significant press attention to SWFs assisting many U.S. financial institutions weather the sub-prime mortgage crisis. Citigroup, Merrill Lynch, and Morgan Stanley, and most recently Credit Suisse have all received cash infusions from SWFs since fall of 2007, and UBS is currently seeking approval to raise funds from Singapore and an unnamed Middle Eastern investor through a sale of bonds. Specific to private equity, China Investment Corporation purchased a block of Blackstone non-voting shares in fall of 2007, and the Carlyle Group and Carlyle Europe are partially owned by the Abu Dhabi Investment Authority.

### **CalSTRS' Private Equity (Alternative Investments) Portfolio**

The Private Equity (called Alternative Investments, or AI, at CalSTRS) portfolio is the 'high octane' of the CalSTRS investment fund, with a present investment commitment of \$13 billion. The Investment Committee added AI to the portfolio in 1991 with a target allocation of 2 percent as a means of increasing the overall rate of return, and in 2000, the target allocation was increased to nine percent. In 2007, the AI portfolio was the highest returning asset class with a 33 percent return. It is also the highest returning asset class over the past five years at 25.875 percent. Compared to other pension systems, CalSTRS has the second highest performing AI portfolio in the United States. While SWF investments in private equity general partnerships just started in 2007, any associated risk has been factored into CalSTRS' due diligence process and also as another aspect of the investment decision.

The CalSTRS investment portfolio is managed and governed by a series of comprehensive investment policies. This helps maintain a consistent and thoughtful investment approach, which experts cite as critical for institutional investment success. Investment managers are required to follow the Geopolitical Risk Policy adopted by the Board. To help identify and evaluate investment risks relating to conditions, such as recognition of the rule of law, shareholder rights, human rights, the environment, acts of terrorism and others, CalSTRS also developed a list of 20 Risk Factors to serve as a guide for its emerging market investment managers to reduce CalSTRS' exposure to crises around the globe.

### **Related State and Federal Policy and Legislation**

Retirement Board Fiduciary Duty. Proposition 162 requires that "the members of the retirement board of a public pension or retirement system shall discharge their duties... solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries... a retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty." This proposition simultaneously permits the State Legislature to "prohibit certain investments of a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section." The intent of the Pension Protection Act (enacted by Proposition 162) includes the statement that, "pension systems [and] retirement board trustees must be free from political meddling and intimidation."

Foreign Policy. The U.S. Constitution provides sole purview of foreign relations and policy to the federal government. There are several federal cases pending in other jurisdictions with respect to recent Sudan and Iran divestment efforts, and similar divestment efforts have

previously been struck down by federal courts. The federal Sudan Accountability and Divestment Act permits but does not require local jurisdictions to divest from Sudan. The President's signing statement, however, simultaneously asserts the federal government's sovereignty in setting foreign policy.

With respect to foreign investment's potential to threaten national security, (as listed in the bill's findings and declarations), foreign acquisitions of U.S. assets that may threaten national security are regulated under the Exon-Florio provision of the *National Defense Production Act* as amended by the *Foreign Investment and National Security Act of 2007*. This legislation requires the president to suspend or prohibit any foreign acquisition, merger, or takeover of a U.S. company if that takeover is determined to threaten national security.

## **ANALYSIS:**

### **Existing Law:**

Existing law permits CalSTRS to invest in and with private equity firms in accordance with the Board's fiduciary duty and Investment Policies.

### **This bill:**

AB 1967 prohibits CalSTRS and CalPERS from increasing or renewing investments with a private equity company wholly or partially owned by a sovereign wealth fund, if the sovereign wealth fund is affiliated with a country that is not a signatory or a party to the terms of at least five of six specified human rights conventions.

If, however, for the most recent year in which these reports were prepared, either (1) the State Department determined that the country generally respects human rights in specified reports or (2) the State Department did not prepare a human rights report on the country, these criteria would not apply, and CalSTRS or CalPERS may only invest with such companies if it:

- 1) Evaluates every sovereign wealth fund owning stock in the private equity company, using publicly available information concerning specified aspects of
  - a) Transparency;
  - b) political stability;
  - c) productive labor practices;
  - d) corporate social responsibility;
- 2) Prepares a detailed written report of the evaluation;
- 3) Considers that evaluation in deciding whether to make or renew an investment in the private equity fund; and
- 4) States in writing what its decision was with respect to investing or not investing;

Lastly, AB 1967 requires CalSTRS to file an annual report with the Legislature starting on January 1, 2010, describing the investments and all decisions to make or not to make an investment in any fund covered by the bill, along with justifications for these decisions in light of the criteria and conventions listed.

Nothing in the bill requires the pension fund to take any action unless the board determines it is consistent with its fiduciary duty. In addition, the Board and CalSTRS officers, but not the fund itself, are indemnified as a result of any evaluation or investment made pursuant to the bill.

**Impact on CalSTRS’ Investments Operations and Portfolio**

AB 1967 will have a profound and significant negative impact on current operations. The bill’s definition of “private equity company” is overly broad and could in fact include real estate partnerships in which CalSTRS invests. Because these partnerships have not permitted SWFs to become partial or whole owners, however, this analysis focuses on CalSTRS’ AI Portfolio.

General partnerships come in several different structures and even have blended public/private ownership structures. CalSTRS has invested with all types and as always factored the general partnership structure into the risk analysis and investment decision. At times, CalSTRS has not made a commitment to a general partnership due to problems with that structure.

As of the end of February 2008, CalSTRS has identified two general partnerships currently within the AI portfolio that are partially owned by SWFs that meet the criteria specified in the bill, both of which are affiliated with the United Arab Emirates. In both cases, ownership provides the SWF with neither a board seat nor voting rights and so yields little—if any—power to influence the general partnership’s business decisions:

<b>General Partnership</b>	<b>SWF with partial ownership (associated country)</b>	<b>SWF’s Stake in General Partnership</b>	<b>CalSTRS Commitment (in millions)</b>
Carlyle Group	Mubadala Development Authority (U.A.E.)	7.5%; no voting rights	\$1,139
Apollo Management	Abu Dhabi Investment Authority (U.A.E.)	Estimated 9.9%; no board seat or voting rights	\$250

According to the United Nations High Commissioner for Human Rights, there are currently nine conventions and international covenants related to human rights. Only six of these conventions and covenants are referenced in AB 1967; the three that are not included address the rights of individuals against ‘enforced disappearance,’ the rights of migrant workers and their families, and the rights of persons with disabilities. Of the six conventions listed in AB 1967, the U.A.E. is signatory or party to only three. Thus, for the purposes of AB 1967, the U.A.E. does not meet the first set of criteria. (The U.S. is a party or signatory to all six of the conventions listed in AB 1967, although the Senate has only ratified three.)

With respect to the second set of criteria, the U.S. Department of State has indicated with respect to the U.A.E., “the government's respect for human rights remained problematic, [with] significant human rights problems reported [in 2006].” Thus the first set of criteria appears to apply, and CalSTRS would likely be required to abstain from making any new or increased investment with either the Carlyle Group or Apollo Management.

Abstaining from investing in either of these funds would likely be a direct violation of CalSTRS fiduciary obligation, and it would have a significant negative impact on the CalSTRS portfolio’s

returns. There are no suitable alternatives to these investments in terms of risk and return profile—hence CalSTRS has selected these investments for the portfolio in the first place. If CalSTRS assumes that it would be prohibited from investing in the two general partnerships highlighted in this analysis, the estimated cost is \$1.5 billion over five years. Looking forward, AB 1967's price tag has the potential to rise significantly. As additional general partnerships seek liquidity by selling a portion of ownership to outside investors, including SWFs, there is a significant opportunity for additional private equity firms to join the list of prohibited investments. At the high end, AB 1967 could cost as much as \$5.3 billion in lost investment revenue over five years. It is worth noting that these figures are net amounts—the calculation assumes funds would be otherwise invested at 7.5 percent return if private equity were not an option.

With respect to the future, AB 1967 becomes even more problematic to implement.

While only two firms fall under the definition of the bill today, there may be at least three other firms that are close to selling a stake of their General Partnership to institutional investors including SWFs that may result in prohibiting CalSTRS from investing with those firms. If the global equity markets do not improve, it is realistic to expect as many as seven other firms, possibly including some of CalSTRS real estate partners, to sell a minority stake to institutional investors. If these additional firms fall under AB 1967, the potential loss of revenue will multiply substantially. By nature, this bill targets the best investment opportunities in the private equity and real estate portfolio because it is the most successful firms that constitute the most attractive general partnership investment.

AB 1967 requires posting CalSTRS' research on general partnerships' ownership structure on the internet 60 days prior to our investment. This provision would conflict with several existing laws and regulations governing the Board's deliberation on investments, and it would likely eliminate or severely curtail investment opportunities. Given the nature of commitments to private equity companies and the confidentiality provisions that are generally included, the 60-day provision alone would make it very difficult – if not impossible – for CalSTRS to invest with a general partnership. Further, CalSTRS considers these investments in Closed Session in accordance with the State rules, and requiring public disclosure of such information may interfere with the Board's fiduciary responsibility to deliberate on investment decisions. AB 1967 also requires the Board to post within 10 days of making an investment the rationale for the investment. Publicly announcing a decision to invest before the negotiation of terms and conditions is completed decimates CalSTRS' ability to aggressively negotiate investments as has been possible in the past when these decisions were confidential until complete.

Although the bill contains provisions that are similar to those included in legislation affecting CalSTRS investments in the Sudan and Iran, the bill can have a significant impact on CalSTRS investments even if the Board exercises its fiduciary responsibilities and declines to undertake the actions required in the bill. This is because the increased regulation of investors, such as CalSTRS, in such investments makes those investors substantially less attractive partners for the private equity managers. The funds affected by this bill are all oversubscribed – if CalSTRS does not commit, other investors, including SWFs, will quickly fill that void. Rather than become embroiled in regulatory matters that do not benefit the investment return, these funds, and other funds with similar demand, will more likely look elsewhere for sources of capital, thereby reducing the opportunities for CalSTRS and CalPERS to earn the returns generated by such funds.

AB 1967 presents several additional legal concerns, as described below.

## **OTHER STATES' INFORMATION**

Recognizing the growing importance of SWFs and the role of the International Monetary Fund (IMF) in monitoring the health of its member countries' economies and the global financial system, the IMF is currently spearheading an effort to create guidelines for SWFs addressing their transparency, governance, disclosure practices, and fund organization. The IMF convened a Roundtable of Sovereign Asset and Reserve Managers in November of 2007 to begin the discussion, and it plans to gather representatives together again in the spring to determine whether they can agree on common practices in these areas. The IMF is aiming to have voluntary guidelines completed by fall of 2008.

Simultaneously, the Organization for the Economic Cooperation and Development (OECD) is developing a voluntary code for countries receiving sovereign wealth funds' capital. These guidelines are expected to address free investment, national security, and strategic industries.

On the federal level, the U.S. Treasury has indicated that SWFs will be expected to adopt the voluntary code of conduct described above as a means of providing assurance that these funds are being used for economic rather than political gain. The current presidential administration is committed to open international investment, as described by President Bush in his May 10, 2007, 'Statement on Open Economics': "As both the world's largest investor and the world's largest recipient of investment, the United States has a key stake in promoting an open investment regime. The United States unequivocally supports international investment in this country and is equally committed to securing fair, equitable, and nondiscriminatory treatment for U.S. investors abroad."

## **FISCAL IMPACT**

Benefit Program Cost – CalSTRS could be required to abstain from future investment with, as of this report, two private equity firms: Carlyle Group, and Apollo Management. CalSTRS estimates the lost revenue from these investments to be \$1.5 billion over five years. Additionally, the provisions of this bill could further hinder or severely reduce the return of CalSTRS' entire Alternative Investments portfolio in the future, with a high-end estimate of \$5.3 billion over five years. There are likely to be three to as many as seven or more firms that may fall under this Legislation within the next year.

Administrative Costs/Savings – Increased annual cost of approximately \$105,500 to provide for one new Investment Officer position, plus any additional costs for outside research services to provide compliance with the bill's provisions. The cost of these services could range \$150,000 to \$300,000.

There are also potential litigation risks associated with this bill. These risks stem from parties who would seek to enjoin the implementation of the bill and parties who would seek to mandate implementation should the Board find the bill could not be implemented in accordance with the Board's fiduciary duty. There may also be litigation from plan beneficiaries who could view the bill as an impairment of contract under both the United States and California constitutions. While the cost of defending these lawsuits is difficult to predict, it is reasonable to expect a minimum of

\$100,000 to \$250,000 should litigation ensue. There will also be additional cost associated with CalSTRS staff counsel and other staff involvement in any litigation.

## **LEGAL IMPACT**

AB 1967 requires CalSTRS to conduct significant research using Teachers' Retirement Fund monies and to publish this information for the public benefit. The Federal Government does not perform this research; therefore any in-house or contracted research would require additional resources be used for investments. As the Teachers' Retirement Fund is to be used, "solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries," any additional research conducted above that required to meet fiduciary responsibility and due diligence requirements could be construed as an improper use of funds. The extent to which this information is then to be shared with the public could be construed as a further violation and gift of state funds.

Additionally, this bill may create an unconstitutional impairment of contracts. Because AB 1967 would effectively cut-off an entire source of funding for the CalSTRS investment portfolio, it would negatively affect CalSTRS' ability to meet its future liabilities. CalSTRS members and beneficiaries have a contractual right to an actuarially sound pension system. The courts have been very consistent in protecting vested pension rights from tampering by the Legislature. To the extent that the bill limits the ability of CalSTRS to secure the level of funding otherwise available, this bill could therefore be considered to impair the contract between CalSTRS and its members and beneficiaries.

Finally, there is a strong argument that AB 1967 intrudes on the foreign affairs power of the federal government because it would affect foreign relations with countries such as the U.A.E. Case law maintains that local laws that "affect international relations in a persistent and subtle way" and that "may adversely affect the power of the central government to deal with problems of international relations" are in violation of the U.S. Constitution (Zschernig v. Miller 380 US 429 (1968)). Because AB 1967 requires the Board to continually evaluate developments abroad and in some cases to conduct a full investigation into the transparency and human rights record of a country, there is a strong argument that this bill is unconstitutional.

## **SUPPORT**

SEIU (sponsor).

## **OPPOSITION**

CalSTRS.

## **LEGISLATIVE STAFF CONTACT**

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## Appendix A

The following table is taken from the U.S. Congressional Joint Economic Committee's February 2008 Research Report 110-21, "Sovereign Wealth Funds."

**Table 1 – Sovereign Wealth Funds & Monetary Authorities Performing SWF Functions with Estimated Assets of \$1 Billion or More (in billions U.S. \$)**

Name	Home Country	Founded	Source of Funds Assets	Assets (US\$ billions)
Abu Dhabi Investment Authority and Corporation (ADIA)	UAE (Abu Dhabi)	1976	Oil	875
Government of Singapore Investment Corporation (GIC)	Singapore	1981	Excess reserves	330
Government Pension Fund-Global	Norway	1990	Oil	322
Saudi Arabia Monetary Agency	Saudi Arabia	n/a	Oil	300
Kuwait Investment Authority	Kuwait	1960	Oil	250
China Investment Corporation	PRC	2007	Excess reserves	200
Hong Kong Monetary Authority Investment Portfolio	Hong Kong SAR, PRC	1998	Excess reserves	140
Stabilization Fund of the Russian Federation	Russia	2004	Oil	127
Temasek Holding	Singapore	1974	Excess reserves	108
Central Hujin Investment Corp.	PRC	2003	Other	100
Reserve Fund	Libya	n/a	Oil	50
Australian Government Future Fund (AGFF)	Australia	2006	Budget surpluses, sale of Telstra	50
Qatar Investment Authority	Qatar	2005	Oil	40
Alaska Permanent Fund	U.S.	1976	Oil	40
Brunei Investment Authority	Brunei	1983	Oil	35
National Pensions Reserve Fund	Ireland	2001	Other	29
Revenue Regulation Fund	Algeria	2000	Oil	25
Korea Investment Corporation	South Korea	2005	Excess reserves	20
National Oil Fund	Kazakhstan	2000	Oil, gas	18
Khazanah Nasional	Malaysia	1993	Debt	18
<i>National Development Fund</i>	<i>Venezuela</i>	<i>2005</i>	<i>Oil, excess reserves</i>	<i>18</i>
Alberta Heritage Savings Trust Fund	Canada	1976	Oil	17
Taiwan National Stabilization Fund	Taiwan	2000	Postal savings, loans from domestic banks	15
New Mexico State Investment Office Trust Funds	United States	1958	Other	15
Foreign Exchange Reserve Fund	Iran	2000	Oil	15
Excess Crude Account	Nigeria	2004	Oil	11
<i>Government Pension Fund</i>	<i>Thailand</i>	<i>1997</i>	<i>payroll taxes</i>	<i>11</i>
		<i>Budget surpluses,</i>		
Superannuation Fund	New Zealand	2003	Other	10
State General Stabilization Fund (SGSF)	Oman	1980	Oil, gas	8.2
<i>Isithmar</i>	<i>UAE (Dubai)</i>	<i>2003</i>	<i>Oil</i>	<i>8</i>
<i>Pension Guarantee Fund</i>	<i>Chile</i>	<i>2007</i>	<i>Budget surpluses</i>	<i>6.8</i>
<i>Dubai International Capital</i>	<i>UAE (Dubai)</i>	<i>2004</i>	<i>Oil</i>	<i>6</i>
Economic and Social Stabilization Fund	Chile	2006	Copper	6

Pula Fund	Botswana	1993	Diamonds	4.7
Permanent Wyoming Mineral Trust Fund	United States	1974	Minerals	3.2
Government Petroleum Insurance Fund	Norway	1986	Oil	2.6
State Oil Fund	Azerbaijan	1999	Oil	1.5
<i>Heritage and Stabilization Fund</i>	<i>Trinidad and Tobago</i>	<i>2006</i>	<i>Oil</i>	<i>1.4</i>
Timor-Lease Petroleum Fund	East Timor	2005	Oil	1.2
<b>Total</b>				<b>3,239</b>
Source: Steffen Kern, <i>Sovereign Wealth Funds – State Investments on the Rise</i> , Deutsche Bank Research, Sept. 10, 2007, and Lyons, Oct. 15, 2007. Amounts from Kerns, unless in italics then from Lyons.				