CALIFORNIA TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Bill Number: AB 2941 (Koretz) (As amended 6/19/06)

SUMMARY:

Assembly Bill 2941:

- Prohibits the California State Teachers' Retirement System (CalSTRS) and the California Public Employees Retirement System (CalPERS) from investing in companies with business operations in the Sudan that are complicit in the Darfur genocide or have specified relationships with the Sudanese government or military;

- Requires the boards of both retirement systems to divest from such companies, consistent with their fiduciary obligations;

- Establishes criteria for determining whether a company is subject to divestiture;

- Requires the retirement boards to report to the Legislature by 1/1/08 regarding the sale or transfer of those investments; and

- Indemnifies from the General Fund board members, officers, employees and investment managers under contract with the retirement systems from liability for their actions.

PURPOSE OF THE BILL:

There is a nationwide movement from the private and public sector to use divestment to place not only political pressure on the government of Sudan to stop the killing in Darfur, but also financial pressure. According to the author, both CalSTRS and CalPERS are in unique positions to put pressure on the Sudanese government to stop supplying arms to the Janjaweed militia. He wants to ensure both public pension systems do not unwittingly contribute to the humanitarian crisis in Darfur.

BOARD POSITION:

Support, if amended to provide indemnification from the state General Fund for CalSTRS' actions associated with the Sudan Divestment Policy adopted by the Teachers' Retirement Board (Board) on June 7, 2006. The CalSTRS' Sudan Divestment Policy is conditioned, in part, upon enactment of legislation that would indemnify board members, officers, agents and employees of the system for all costs, liability and losses associated with its implementation.

LEGISLATIVE HISTORY:

AB 2179-Leslie, 2006, indemnifies from the state General Fund all current or former regents, officers, employees, and contractors of the University of California (UC) from all claims, demands, suits, actions, damages, judgments, etc., and all liability that they may sustain by reason of any decision of the UC Regents not to invest in any company or firm involved in significant business activities that provide revenue to the Sudanese government.

Resolution Chapter 57, Statutes of 2005, (AJR 6-Koretz) urges the government of Sudan to condemn human rights abuses, war crimes, and crimes against humanity being committed by the state-sponsored Militia, and move towards national reconciliation. It requests the President and Congress to continue to take all prudent and necessary steps to ensure that these matters are addressed at the highest levels of the federal government.

Resolution Chapter 98 Statutes of 2005, (ACR 11-Dymally) requests that CalPERS and CalSTRS, whenever feasible and consistent with their fiduciary responsibilities, encourage companies in the funds are invested and that are doing business in Sudan to act responsibly and not take actions that promote or otherwise enable human rights violations in the Sudan.

Chapter 30, Statutes of 1994 (SB 1285-Watson) repeals provisions of Chapter 1254, Statutes of 1986, prohibiting investments in South Africa.

Chapter 1254, Statutes of 1986 (AB 134-M. Waters) prohibits the use of state trust funds or state moneys to make additional or new investments, or to renew existing investments in firms doing business with or in South Africa.

BACKGROUND

With an approximately $145 billion portfolio, CalSTRS is invested in a wide variety of securities around the globe. As such, CalSTRS assets are invested in many multi-national companies that do business across the world. Some of these companies carry on business in countries where the United States government or the United Nations (UN) have expressed concerns about human rights conditions. In addition, some portfolio companies are located in countries that have opposing perspectives and judge other countries' treatment of their citizens differently than does the United States. In circumstances of extreme crisis situations, such as Darfur, these different perspectives become divisive and test our confidence and comfort with an investment with those corporations.

Darfur, a region in the East African nation of Sudan, has periodically experienced civil war for the past 20 years. In recent years, a rebel uprising has triggered widespread violence that has killed tens, perhaps hundreds of thousands of individuals and displaced millions more, including atrocities attributed to Sudanese government forces by both the United States Government and the UN. In November 1997, President Clinton issued Executive Order 13067, imposing a trade embargo and total freeze of assets located in the United States against the Government of Sudan in response to findings that its actions, including support of international terrorism, efforts to destabilize neighboring governments, and human rights violations within its own borders, constituted an extraordinary threat to American national security. The U.S. Department of Treasury is responsible for implementing and continuing to monitor the embargo.

On March 16, 2006 the University of California (UC) Board of Regents reviewed the findings of a task force to assess the legal and financial implications of divestment from nine companies with significant business operations in the Sudan, and constructively engage with other companies. The Regents voted to divest, subject to receiving indemnification, all UC shares, including the University's pension and endowment funds in the following companies: Bharat

Heavy Industries, Ltd, China Petroleum and Chemical Corporation (Sinopec), Nam Fatt Company Bhd., Oil and Natural Gas Company, Ltd., PECD B, PetroChina Company, Ltd., Sudan Telecom Company, Ltd., (Sudatel), Tatneft OAO, and Videocon Industries, Ltd.. As of April 2006, CalSTRS has holdings in only four of the nine companies on the UC divestment list, which are worth approximately $12 million. The UC is currently sponsoring AB 2179 (Leslie) which would provide indemnification to the Regents and their investment managers. The legislation, however, does not provide indemnification to the UC funds themselves.

CalPERS Actions Related To Sudan

Along with CalSTRS and other major public pension systems, CalPERS is a member of the Sudan Coalition, whose members have worked together to engage portfolio companies and the federal government in efforts to end the suffering in Darfur. CalPERS does not have holdings in the nine companies doing business in Sudan that the UC voted to divest. In May, however, the CalPERS Investment Committee adopted a 9 point position statement concerning companies doing business in Sudan to condemn the atrocities occurring in Darfur. The principles also indicate “CalPERS' belief that a constructive engagement plan is the most powerful tool to effect change at those portfolio companies whose business operations in Sudan could lead to value destruction.”

Among other things, CalPERS’ Constructive Engagement Plan seeks to identify and engage additional companies doing business in Sudan by:

- Contracting with the Institutional Shareholder Services (ISS) to gain access to its database of companies identified as doing business in Sudan.
- Analyzing the appropriate companies for engagement.
- Requesting companies determined to be supporting the government of Sudan and/or the military, or that are complicit in the genocide occurring in Sudan, to not do business with the Sudan government while the human rights violations continue.
- Requesting that companies work with certain Non-Governmental Organizations to improve the transparency of their business operations and complete complicity reports relating to human rights violations in Sudan, and ultimately bring an end to human rights violations occurring in Sudan.
- Engaging companies against which the federal government has levied penalties for violating specific federal sanction programs.
- Continuing to seek new and reliable information sources to identify and engage companies doing business in Sudan, and
- Continuing to work with Sudan Coalition and collaborate where appropriate.

The CalPERS Board recently adopted a neutral position on AB 2941 with suggested amendments to provide full indemnification from the State General Fund for any CalPERS investment losses, in addition to indemnifying members of the CalPERS Board, CalPERS’ officers, employees and investment managers.

CalSTRS Investment Policies and Practices

The fiduciary standards in the Teachers' Retirement Law require the Board, CalSTRS officers and employees to discharge their duties with respect to CalSTRS solely in the interests of the members and beneficiaries for the exclusive purpose of providing benefits, and to defray reasonable expenses of administering the plan.

Under the provisions of Article XVI, Section 17 of the California Constitution, as amended by Proposition 162 (The Pension Protection Act of 1992), the Board has plenary authority and fiduciary responsibility over the investment of retirement plan assets. The authority confers upon the Board the exclusive duty to manage and diversify those assets with the care, skill, and diligence of a prudent person engaged in a similar enterprise, so as to maximize investment returns and minimize the risk of loss. When considering investments, the preservation of principal and maximization of income is the primary and underlying criteria for the selection and retention of securities. The Constitution also states, however, that the Legislature may, by statute, continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

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. Over the past years, the Board's Investment Committee has dealt with major issues of geopolitical risk. To help identify and evaluate investment risks relating to conditions such as recognition of the rule of law, shareholder rights, human rights, the environment, and others, CalSTRS has developed a list of 20 Risk Factors to serve as a guide for its emerging market investment managers to reduce CalSTRS' exposure to crisis situations around the globe.

The Investment Committee has actively debated the proper course of action regarding CalSTRS' investment exposure to companies conducting business in the Sudan since September 2005. During that time, CalSTRS staff has actively engaged company executives to evaluate the exposure and attempt to affect change in accordance with ACR 11 (Dymally). As part of a coalition of institutional investors, CalSTRS actively engaged seven portfolio companies that have been conducting business in Sudan to identify the extent of their business activities and relationships with the Sudanese Government, as well as their efforts to prevent or alleviate human rights abuses occurring there. All the companies provided responses and the coalition found no evidence that they engaged in activities supporting genocide and human suffering. Nevertheless, CalSTRS recognizes there are other companies conducting business in Sudan, and has attempted to identify all of them and evaluate their involvement in supporting the genocide or the Sudanese Government's involvement in the genocide.

To assist in this effort, CalSTRS has retained the services of ISS and KLD Research. They have identified over 100 international firms that sell products or services within the Sudan, ranging from oil exploration firms to retail products. In recent months, the research had been fine-tuned to focus only on companies doing business with the government of the Sudan. Through discussions with the leader of UC Students for Divestment of Sudan and a review of the UC Regents criteria, CalSTRS has created a list that differentiates between firms that are attempting to resolve the human rights abuse in the Darfur Region, from ones that are silent or even complicit in the atrocities.

The culmination of these CalSTRS policy initiatives occurred at the June 7, 2006 meeting of the Investment Committee, when it adopted changes to the CalSTRS Investment Policy to implement a comprehensive plan that recognizes the financial and administrative risks associated with corporate decisions that support Government-endorsed genocide, as identified by the U.S. government, or that violate the 20 Risk Factors adopted by the Board, including a lack of respect for the rule of law and human rights.

While CalSTRS investments are not selected or rejected based solely on the basis of geopolitical and social risk factors, they are taken into consideration to the extent that such factors bear on the financial advisability of the investment (e.g., not investing in a corporation whose conduct has demonstrated a negative effect on the corporation's financial viability). Under the recently adopted changes in investment policy, CalSTRS will directly engage the management of portfolio companies that violate these policies to seek a change in corporate behavior, through letter writing, meetings, participation in advocacy groups, media campaigns, proxy voting and other means. If CalSTRS staff have made all reasonable efforts to constructively engage management and there is a clear nexus between the corporate behavior and the CalSTRS policy violation, and in the Chief Investment Officer's opinion, the corporate remedies are insufficient or non responsive, CalSTRS will, if prudent and consistent with CalSTRS' fiduciary duties:

- Inform its active investment managers that, to the extent that suitable alternative investments are available and that their inclusion in the portfolio would result in no diminution in portfolio return or increase in risk the managers shall invest in said alternative(s) until such time as the violations of the policy cease.

- Passive portfolios will cease to acquire shares of companies in violation of this policy until such time as the policy violations cease.

- Upon remedy of the policy violation, CalSTRS will inform the active investment managers and passive managers that the securities can be purchased.

This policy change is subject to the enactment of legislation to indemnify the Board, CalSTRS staff and investment managers from the General Fund for their actions related to this policy change. It is the Board's intent that when violations of this policy occur, CalSTRS will seek indemnification from the General Fund through legislation.

In the case of the situation in Sudan, these actions follow the same general guidelines adopted by the UC Regents. Under similar criteria used by the UC Regents and UC students' divestment taskforce, the list of companies identified by CalSTRS staff, ISS and KLD, is scaled to reflect the various levels of potential human rights risks. In some cases, the companies identified require further review before they can be ranked on the list. The key distinction between targeted companies and those that are under review is the limited evidence or verifiable data that certain companies are not attempting to reduce the risk of the situation or are in fact contributing in some way to worsen the human rights violence. Since the volume of information, the condition of the crisis, and company's actions are dynamic and fluid, the list – and a company's ranking on that list – may change.

Once indemnification is secured, the CalSTRS investment staff will forward its external investment managers the list of firms identified as doing business with the Sudanese Government that contribute to, or are complicit in the genocide, and request that they find other potential available investments that are equally advantageous from an economic perspective. Given the abundance of investment opportunities in the emerging markets and the affected sectors, CalSTRS staff and the Board's General Investment Consultant do not believe it will be difficult for investment managers to find reasonable alternatives for these companies.

By placing the geopolitical risk segment in the overall risk section of the CalSTRS Investment Policy and Management Plan, the 20 Risk Factors originally developed for the Emerging Markets Portfolio will be applied to the entire CalSTRS Portfolio. This change helps the Investment Committee manage both this current risk related to Sudan and future geopolitical risk issues to further ensure that all investment decisions made, by either internal or external investment managers, consider the 20 Risk Factors when making an investment decision.

The danger of this policy, as with any limit on CalSTRS' investment universe, is the potential loss of an investment opportunity. As companies accept various risks in their business operations as identified in the CalSTRS 20 Risk Factors, it sometimes yields short term profits which boost the price of their securities. As a result, over short time frames, these companies may outperform other alternatives at the expense of their long-term sustainability. While CalSTRS investment managers may find suitable alternative investments, only time will reveal how these alternatives perform compared to the original investments.

ANALYSIS

Specifically, Assembly Bill 2941:

- Expresses legislative intent which, among other things: "acknowledges that divestment is a course of last resort that should be used sparingly and under extraordinary circumstances. This act is based on unique circumstances, specifically, the reprehensible and abhorrent genocide occurring in Sudan" … and "is not intended to set precedent with regard to divestment policies and practices by public retirement and pension funds in California."

- Requires CalSTRS' divestment of portfolio holdings in companies either demonstrating complicity in the Darfur genocide; furnishing to the Sudanese government military equipment or equipment that may be used for military purposes; OR are engaged in business operations that provide revenue to the government of Sudan or in oil-related activities in Sudan and has failed to take "substantial action" defined as boycotting the Sudanese government, curtailing operations in the country, selling various assets in-country, or undertaking significant humanitarian efforts in the eastern, southern, or western regions of Sudan.

- Requires CalSTRS to contract for research services to identify companies meeting the criteria listed above by 3/30/07, and submit further findings if circumstances change in Sudan. Also requires the Board to review publicly available information regarding companies with business operations in Sudan. Contact other institutional investors that invest in companies with business operations in Sudan.

There are three significant differences between the effect of the Investment Committee's actions and the proposed legislation. Although the policy change may result in CalSTRS divesting or selling the same companies that are the focus of the bill, the current CalSTRS practice recognizes the fluidity of the situation and allows more flexibility as to the time of the liquidation and identification of which companies to sell. It is important to note that CalSTRS' current practice may result in liquidation more quickly than required by the bill. The bill, however, contains hard cut-off dates, which are not adjusted or adapted to changes in the crisis as quickly as current CalSTRS practice allows. As a long-term investor, CalSTRS' first step in any difficult situation is a direct engagement with corporate management in an attempt to influence and motivate change. This direct dialog helps both sides learn more about the different perspectives of a situation and appreciate each other's point of view. As long-term owners, active engagement is a much more effective tool compared to simply selling the stock to another investor. When we sell, it removes CalSTRS voice from corporate management and, in the end, it does not hurt the corporation, since we're just selling our stock to another investor. Corporations have admitted to staff that they are often unaware when a pension fund sells their stock unless the pension fund issues a press release announcing the sale.

In the Sudan crisis, CalSTRS investment staff has met directly with several firms to discuss their exposure to the Sudan, their human rights ethics, the crisis situation, and their activities to improve the situation. When these discussions prove fruitless, CalSTRS informs its investment managers who will factor that into their review of that investment. By following these steps, CalSTRS is following its fiduciary duty and affecting a reduction of its risk. This bill takes more immediate steps toward divestment and more quickly removes CalSTRS as a voice of change in corporate management.

A second difference, depending upon how the bill is interpreted, is the evaluation criteria for selecting companies for divestment. CalSTRS current practice is to follow the same general guidelines as the U.C. Regents, providing a fairly clear picture of which companies to focus on. However, the bill could be interpreted to include many companies that are not directly involved in the situation or who have intentionally frozen all activity until the human rights situation improves.

Finally, although the bill requires the General Fund to indemnify the Board and CalSTRS staff and investment managers for any personal liability associated with divesting stock pursuant to this bill, a prerequisite for execution of the policy change adopted by the Investment Committee, the bill indemnifies CalSTRS officials and managers only for actions undertaken pursuant to the bill's provisions. As a result, it appears that if CalSTRS divests itself of securities pursuant to its own policy, in a manner that is not consistent with the bill, the bill's indemnification provisions would not apply. This is inconsistent with the indemnification contained in the UC bill, which does not specify any specific mechanism of divesting the securities.

In addition, the bill as drafted does not actually appropriate money from the General Fund to pay damages; such an appropriation would have to come from subsequent legislation. While a similar weakness appears in the UC divestment legislation, the provisions of the bill appear more a statement of intent of future legislative action, rather than a complete indemnification of

CalSTRS' officials and managers. This problem could be clarified by specifying that claims on the General Fund resulting from a successful court challenge be filed with the Victim Compensation & Government Claims Board. It should also be noted that, consistent with the proposed UC indemnification provisions, the indemnification does not extend to any investment losses experienced by the fund itself from any divestment. This is consistent with the limited indemnification provided in the South Africa divestment legislation in 1986.

FISCAL IMPACT

Benefit Program Cost – While the performance of the investment portfolio affects the ability to fund the benefits CalSTRS may offer its membership, AB 2941 does not directly impact CalSTRS' benefit programs. The financial impact on the investment portfolio is difficult to measure since the Investment Committee is also moving toward liquidating investments in these firms. There is always a potential opportunity cost to not investing in certain securities. Any time there is a reduction in the universe of potential investment opportunities, there is the chance that the companies eliminated would offer greater investment returns. Since many of these are oil and gas exploration firms, and given the current high price of crude oil, these stocks have produced spectacular returns and in some cases a 200 percent increase in just one year. The actual cost of engagement and divestment will depend on variables such as: (1) companies identified for divestment, (2) criteria for divestment, (3) CalSTRS' holdings in those companies, and (4) timing for such divestment not to mention the opportunity cost associated with the loss of that company to the investment portfolio.

Administrative Cost/Savings – Costs to contract with an outside research firm for services identifying the companies and the extent to which they conduct business in Sudan will be approximately $50,000 to $80,000 per year over two years, beginning in 2007-08, with ongoing monitoring services costing somewhat less in following years.

OTHER STATES LEGISLATION

Three states have taken the lead enacting public divestment statutes, including Illinois, New Jersey and Oregon. Other states including Connecticut, Indiana, Massachusetts, Ohio, New York, North Carolina, Texas and Vermont, have divestment legislation pending. Other states have implemented "Divest Terror" plans that target not only Sudan, but any country or company with links to terrorism. In the private sector, universities such as Amherst, Yale and Stanford have implemented restrictions on Sudan investments, and several others universities are considering similar divestment plans.

In June, 2005, Illinois enacted Chapter 130, Public Act 94-0079, (SB 23-Collins). The new law took effect January 1, 2006, and provides the affected retirement systems until July 1, 2007 to fully divest. So far, the $36.4 billion Teachers' Retirement System of Illinois, (TRSI) divested $2.4 billion from U.S. and non-U.S. equity index funds. TRSI plans to sell off securities in another 41 companies representing nearly $900 million. Officials at the $10.7 billion Illinois State Board of Investment (ISBI), and the $14.5 billion State Universities Retirement System (SURS), and $6.2 billion Cook County Annuity & Benefit Fund, are working with managers to identify vulnerable investments, but have not yet sold any stock. According to recent newspaper reports, the National Foreign Trade Council (NFTC) is expected to file suit in federal court challenging the Illinois law violated the supremacy of the federal government in foreign policy. The NFTC has previously been successful in a similar lawsuit, which challenged a Massachusetts law banning state contracting with companies doing business in Myanmar.

In July 2005, New Jersey enacted Chapter 162, Public Law of 2005, (A.3482-Payne). It requires divestment of state pension fund investments from companies and financial institutions that have ties to, or activities in Sudan. According to the New Jersey State Treasurer, the $73 billion New Jersey Division of Investment, (NJDI), plans to divest $2.1 billion in shares of 17 companies they have identified as doing business in Sudan. It has already divested approximately $850 million in assets and expects to complete the remainder of the divestment by mid-summer – two years ahead of the statutory deadline.

In August 2005, Oregon enacted Chapter 774, Laws of 2005, (SB 1089--Buckley) which requires the Oregon Investment Council (OIC) and the State Treasurer to divest all Sudanese-related investments. The $57 billion Oregon Public Employees Retirement System (OPERS), is divesting $35 million worth of shares of PetroChina Co., Ltd., Sinopec Corp., ABB, Ltd, and Tafnet OAO.

SUPPORT AND OPPOSITION:

Support: Sudan Divestment Task Force and Sacramento Committee on Conscience, (Co-sponsors); Phil Angelides, State Treasurer; California Federation of Teachers; American Federation of State, County and Municipal Employees.

Opposition: None known.

PROS AND CONS:

PROS:
- AB 2941 recognizes that every fiduciary has different considerations when evaluating the situation in Sudan.
- AB 2941 mandates engagement with companies before any divestment decision is made.
- AB 2941 enforces a deadline for companies to demonstrate they are taking substantive action to end the genocide in Darfur.
- Economic development is critical in a country striding towards democratization and improved living standards. Targeted divestment may serve to limit the scope of divestment to the worst offenders.

CONS:
- AB 2941 affects only two pension systems and divestment will not affect the investments of other California public pension systems.
- The timelines prescribed in AB 2941 may not be sufficient given the multitude and complexity of factors that will determine success.
- AB 2941 does not indemnify the Teachers' Retirement Fund from investment losses.
- AB 2941 invites litigation similar to the National Foreign Trade Council (NFTC)'s lawsuit on Sudan Divestment against the State of Illinois.