BILL NUMBER: AB 20 (Kalra) as introduced December 5, 2016

SUMMARY

AB 20 prohibits the CalSTRS and CalPERS boards, subject to fiduciary duty, from making additional investments or renewing existing investments, on or after January 1, 2018, in a company constructing, or funding the construction of, the Dakota Access Pipeline. Also, the bill requires the CalSTRS and CalPERS boards, subject to fiduciary duty, to liquidate their investments in a company constructing, or funding the construction of, the pipeline on or before July 1, 2018.

BOARD POSITION

Oppose, unless amended, to remove the prohibitions on new or renewed investments and requirements for liquidation of existing investments in the specified companies; to require a report to be submitted to the Legislature on engagement activities with those companies; and to indemnify present, former and future board members, officers and employees of and investment managers under contract with the system for any actions related to the bill**.** The board's policy is to oppose legislation that infringes on the investment authority of the board or is inconsistent with the investment policy adopted by the board as presented in the CalSTRS Investment Policy and Management Plan.

REASON FOR THE BILL

Several Native American tribal nations and environmental groups have expressed concern and protested against the Dakota Access Pipeline, citing concerns about negative impacts to the environment, including potential contamination of water sources, and other adverse impacts to the reservation of Sioux tribes that are in close proximity to the pipeline’s route.

ANALYSIS:

Existing Law:

Under the provisions of Section 17 of Article XVI of the California Constitution, as amended by Proposition 162 of 1992, the CalSTRS board has plenary authority and fiduciary responsibility over the investment of retirement plan assets and is required to discharge its duties solely in the interests of the members and beneficiaries for the exclusive purpose of providing benefits. The board must invest the assets of the plan with the care, skill and diligence of a prudent person engaged in a similar enterprise so as to maximize the investments 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 states, however, that the Legislature may by statute prohibit certain investments by a retirement board when 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.

This Bill:

Specifically, AB 20:

- Prohibits the boards of CalSTRS and CalPERS, subject to fiduciary duty, from making additional investments or renewing existing investments, on or after January 1, 2018, in a company constructing, or funding the construction of, the Dakota Access Pipeline; and
- Requires the boards of CalSTRS and CalPERS, subject to fiduciary duty, to liquidate their investments in a company constructing, or funding the construction of, the Dakota Access Pipeline on or before July 1, 2018.

This bill presents a unique situation because the proposed restriction is based on one specific construction project, which is unlike previous divestment measures that have tended to apply to a sector of business or to business activity in a specified country. There is no clear indication whether CalSTRS would be prohibited from making new investments in the restricted companies once the pipeline construction is completed. If the intent is to extend the restriction beyond the completion of the pipeline construction, there is no indication in the measure as to when CalSTRS would be able to make new investments in the restricted companies since the measure does not contain a sunset provision. These circumstances present uncertainties as to how CalSTRS would comply with the requirements and restrictions. Finally, the legislation does not contain an indemnification clause for present, former and future board members, officers and employees of and investment managers under contract with those retirement systems for actions related to the bill, and it does not indemnify the fund or allocate any funds for the losses it may sustain by divesting.

The board's policy is to oppose legislation that restricts its ability to invest in specific areas because, as described in its divestment policy, such restrictions could impair the board’s ability to exercise its fiduciary obligation to act exclusively for the benefit of the retirement plan members and beneficiaries. Divestment bears the risk of adversely affecting an investment portfolio. This is especially concerning as investment returns affect the 2014 funding plan (AB 1469–Bonta), which placed CalSTRS on a trajectory toward full funding.

In accordance with its divestment policy, CalSTRS has historically advocated that active and direct engagement is the best way to resolve issues, and divestment severs any chance to advance positive change through shareholder advocacy. A report to the Legislature on CalSTRS engagement with companies involved with the Dakota Access Pipeline would demonstrate what types of efforts have taken place and what the outcomes of those efforts are.

LEGISLATIVE HISTORY

<u>SB 185 (De León, Chapter 605, Statutes of 2015)</u> required the CalSTRS and CalPERS boards to engage with thermal coal companies, as defined, and to divest the public employee retirement funds of any investments in thermal coal companies and prohibited additional or new investments or the renewal of existing investments in thermal coal companies.

AB 761 (Dickinson, 2013) would have prohibited CalSTRS and CalPERS from investing in companies that manufacture firearms or ammunition for a recipient other than the U.S. military, subject to a process specified in the bill and consistent with previous divestment legislation, but subject to the board's fiduciary duties. This bill was held in the Assembly Appropriations Committee.

SR 18 (Leno, Adopted, 2013), in response to the Russian government taking an aggressive course of action to pass laws targeting the lesbian, gay, bisexual and transgender (LGBT) community, strongly encouraged CalSTRS and CalPERS, whenever feasible and consistent with their fiduciary responsibilities, to cease making direct investments in Russia and to encourage companies in which employee retirement funds are invested and that are doing business in Russia not to take actions that promote or otherwise enable human rights violations in Russia.

AB 1151 (Feuer, Chapter 441, Statues of 2011) required that any determination by CalSTRS that an action, as specified in the California Public Divest from Iran Act, fails to satisfy the fiduciary duty of the board be made in a properly noticed public hearing of the full board and that proposed findings be made public 72 hours before they are considered by the board.

AB 221 (Anderson, Chapter 671, Statues of 2007) enacted the California Public Divest from Iran Act prohibiting CalSTRS and CalPERS from investing in companies with business operations in Iran and requiring each pension system to sell or transfer any investments in a company with business operations in Iran. Required, when the U.S. repeals its sanctions against Iran, the pension boards notify the Secretary of State and the prohibitions and requirements in this bill be repealed.

AB 2941 (Koretz, Chapter 442 Statues of 2006) prohibited CalSTRS and CalPERS from investing in companies with business operations in Sudan that are complicit in the Darfur genocide or have specified relationships with the Sudanese government or military and required the boards of both retirement systems to divest from such companies, consistent with their fiduciary obligations.

PROGRAM BACKGROUND

ESG Policy

CalSTRS has its own well-established and longstanding process for thoroughly vetting the environmental, social and governance risks of potential investments. The board adopted its Statement of Investment Responsibility in 1978, making CalSTRS an industry leader as one of the first pension funds to adopt a written policy to navigate these complex issues. In its latest incarnation, the board developed a list of 21 Risk Factors as part of its Investment Policy for Mitigating ESG Risks. The 21 Risk Factors help the board to identify and evaluate investment risks relating to the existence of certain conditions, such as recognition of the rule of law, shareholder rights, human rights, the environment, acts of terrorism and other unsustainable practices and governance crises with the potential to hurt long-term profits.

Divestment Policy

In addition to the CalSTRS ESG policy, the board has adopted a divestment policy, focusing on engagement, to respond to external or internal initiatives to divest of specific companies or industries. In accordance with this policy, CalSTRS has historically taken the position that active and direct engagement is the best way to resolve issues. Divestment bears the risk of adversely affecting an investment portfolio and severs any chance to advance positive change through shareholder advocacy. Face-to-face meetings with shareowners and senior management, or the board of directors, are generally more effective in bringing about change in a corporation. Under the policy, the board will only consider divestment after all efforts at engagement have failed, and only then in cases where at least one of the 21 Risk Factors is violated over a sustained timeframe to the extent that it becomes an economic risk to the fund, creates a potential for material loss of revenue and weakens the trust of a significant portion of CalSTRS members. Finally, the divestment policy sets forth that the board will only instruct staff to divest of a security when it determines that continuing to hold a security is imprudent and inconsistent with its fiduciary duty.

Dakota Access Pipeline

The Dakota Access Pipeline is an underground oil pipeline project that covers a distance of nearly 1,200 miles, stretching from shale oil fields in northwest North Dakota to an oil tank farm in southern Illinois. Several Native American tribal nations and environmental groups have expressed concern and protested against the pipeline, citing concerns about negative impacts to the environment, including potential contamination of water sources, and other adverse impacts to the reservation of Sioux tribes that are in close proximity to the pipeline’s route. The U.S. Army Corps of Engineers, after initially denying, approved an easement in early 2017, and construction of the pipeline has now been completed.

OTHER STATES' INFORMATION

To date, no other state has enacted legislation related to divestment from a company constructing, or funding the construction of, the Dakota Access Pipeline.

FISCAL IMPACT

Program Cost – Direct exposure to four companies constructing of the Dakota Access Pipeline is approximately $205 million in debt and equity. In addition, if the scope of companies is broadened to include banks that are funding the project, banks that have relationships with the builders of the project, and other traded subsidiaries and possible construction partners, estimated exposure is approximately $8.4 billion. CalSTRS may incur opportunity costs if suitable alternative investments are unavailable or if such alternative investments do not provide an investment return that meets or exceeds those of the divested securities. Any resulting costs would increase the unfunded liability and also may result in an increase in the state’s contribution to the Defined Benefit Program.

Administrative Costs/Savings – Approximately $800,000 to $1.3 million to divest from the four companies constructing the pipeline and up to $28.7 million to also divest from a broader scope of companies that may fall within the divestment requirements. Implementation and ongoing compliance will also require reallocation of staff resources.

SUPPORT

None known.

OPPOSITION

CalSTRS (oppose, unless amended)

ARGUMENTS

Pro: Could reduce the perception that CalSTRS is contributing to climate change.

Con: May infringe upon the investment authority of the board.

May reduce the investable universe and adversely affect portfolio performance.

Creates uncertainty as to whether divestment is still required once construction of the pipeline is completed.

Establishes an indefinite limitation on the investable universe while the project is finite.

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