BILL NUMBER: AB 761 (Dickinson) as amended March 19, 2013

SUMMARY

AB 761 prohibits 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.

BOARD POSITION

NEUTRAL, if amended, to limit the requirement to manufacturers of firearms and ammunition in which such lines of business represent a minimum percentage of the company's revenues, such as 15 percent, to indemnify the board and staff for losses to the Teachers' Retirement Fund that may result from carrying out the bill's provisions, and to remove the phrase "in good faith."

REASON FOR THE BILL

This bill seeks to prohibit CalSTRS and CalPERS from investing in companies that manufacture firearms or ammunition for a recipient other than the United State military because of the significant social harm that firearms can cause, as evidenced by recent tragic events in this country, such as the events of December 14 at Sandy Hook Elementary School in Connecticut.

ANALYSIS:

Existing Law:

The fiduciary standards in the Teachers' Retirement Law require the Teachers' Retirement Board (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. Under the provisions of Section 17 of Article XVI of the California Constitution, as amended by Proposition 162 of 1992, the board has plenary authority and fiduciary responsibility over the investment of retirement plan assets.

The Constitution 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.

This Bill:

AB 761 would prohibit CalSTRS from investing in companies that manufacture firearms or ammunition for a recipient other than the United States military, which is a broader application than the position previously adopted by the board that prohibits CalSTRS from investing in companies that manufacture firearms and ammunition that are illegal for sale in California. The bill does not include a threshold standard to exempt companies whose manufacturing of firearms or ammunition make up a small percentage of their total business. Setting a 15 percent minimum threshold would reduce the impact of the bill to an estimated $4 million of the CalSTRS portfolio, excluding the companies currently subject to divestment under the position adopted by the board.

The measure also requires CalSTRS to engage in a specified process with any company that manufactures firearms or ammunition in which it has an investment through an externally and actively managed commingled fund, an alternative fund, or a private equity investment. At the same time, CalSTRS would be required to engage with the external fund manager to request that either the company be removed from the fund or that the manager create a new fund or account that excludes any manufacturer of firearms or ammunition.

Under this measure, CalSTRS would request that the manufacturer of firearms and ammunition sell assets, equipment, or real and personal property that are firearms-related (substantial action) no later than 90 days after being notified that it is subject to the provisions of this measure. If CalSTRS determines that the company has taken substantial action or has made sufficient progress toward substantial action, then the company would not be subject to divestment. CalSTRS would continue to monitor and review, at 90-day intervals, the progress of the company until it has taken substantial action. If the company does not complete substantial action within a year of the initial notice from CalSTRS, the company would be subject to divestment.
The board would be required to make a determination that a manufacturer of firearms and ammunition has taken substantial action by adopting findings in support of the determination by roll-call vote of the board in an open session during a properly noticed public hearing of the full board. Proposed findings of the board would have to be made public 72 hours before they are considered by the board, and interested parties would be notified of proposed findings. The board would not be required to take the actions as described in this measure if such actions would fail to satisfy the board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.

Starting on January 1, 2015, CalSTRS would be required to file a report with the Legislature that would include a list of all the firearms and ammunition manufacturers in which CalSTRS has investments, as well as a detailed summary of each company's business operations.

Lastly, this measure does not indemnify the board and staff for losses to the Teachers' Retirement Fund that may result from carrying out the requirements of this measure.

LEGISLATIVE HISTORY

<u>AB 221 (Anderson, Chapter 671, Statutes of 2007)</u> 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 shall notify the Secretary of State, and the prohibitions and requirements in this bill will be repealed.

<u>AB 2941 (Koretz, Chapter 442, Statutes of 2006)</u> prohibited CalPERS and CalSTRS 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. It also required the boards of both retirement systems to divest from such companies, consistent with their fiduciary obligations.

AB 2179 (Leslie, Chapter 441, Statutes of 2006) 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.

ACR 11 (Dymally, Resolution Chapter 98, Statutes of 2005) requested that CalSTRS and CalPERS encourage companies in which employee retirement funds are invested and 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. The bill was held in Assembly Appropriations Committee.

AB 134 (Waters, Chapter 1254, Statutes of 1986) 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

One of the board's core values is to ensure the strength of the retirement system by proactively addressing the risks of investing. This value permeates the investment portfolio, where the board has adopted the Investment Policy for Mitigating Environmental, Social, and Geopolitical Risks (ESG). The policy requires managers to consider 21 separate risk factors when investing for CalSTRS.

To review and evaluate issues that fall under the 21 Risk Factors, CalSTRS staff developed the 21 Risk Factor Review Committee. The committee reviews issues relating to divestment legislation and campaigns, labor issues, CalSTRS tobacco divestment, other health-related issues, and tracking geopolitical issues around the world to identify potential risks to the fund. The 21 Risk Factor Review Committee consists of senior staff members from all investment units including: the Chief Investment Officer, the Deputy Chief Investment Officer, two staff members from Global Equities, two staff members from Fixed Income, two staff members from Corporate Governance, one staff member from Private Equity, one staff member from Real Estate, two staff members from Operations, and one staff member from the Innovation and Risk Group.

In addition to the CalSTRS Geopolitical Risk Policy, the board has adopted a divestment policy that allows the board to exclude investments in companies in cases where at least one of the CalSTRS 21 Risk Factors is violated over a sustained timeframe to the extent that it becomes an economic risk to the Fund, a potential for material loss of revenue exists, and where it weakens the trust of a signification portion of CalSTRS members.

The CalSTRS divestment policy consists of three distinct steps: Engagement, Evaluation, and Divestment. CalSTRS firmly believes that active and direct engagement is the best way to resolve issues. Face to face meeting with shareowners and senior management, or the board of directors, are essential to bring about change in a corporation. If engagement fails to resolve the issue, the Investment Committee will then review input from investment managers, investment consultants, investment staff, fiduciary counsel, academics, and experts in the particular field or issue. Finally, if the Investment Committee determines that making an investment or continuing to hold a security is imprudent and inconsistent with its fiduciary duty, it will instruct investment staff to remove the security from the portfolio.

At its meeting on January 9, 2013, the Investments Committee of the board directed staff to implement the CalSTRS Divestment Policy, in a timely and prudent fashion consistent with fiduciary duties, in order to divest of companies that manufacture firearms or large capacity magazines that are illegal for sale to, or possession by, private individuals in California under state law.

FISCAL IMPACT

<u>Program Cost</u> – The impact to the Teachers' Retirement Fund of the bill's current provisions is difficult to estimate, but could be significant because this measure could eliminate large companies and potentially significant portions of the firearms and ammunition sectors from the investable universe. This would reduce portfolio diversification and would very likely affect portfolio performance.

<u>Administrative Costs/Savings</u> – There would be additional costs related to the staff resources needed to comply with this measure. Staff time would be required to produce the annual report required by this measure. There would be transaction costs from liquidating securities. CalSTRS would need to incur the cost of a research provider to identify and maintain a list of firearms and ammunition manufacturers, and the added cost to have benchmark providers provide benchmarks that are free of restricted securities.

SUPPORT

None known.

OPPOSITION

None known.

ARGUMENTS

Pro: Ensures that CalPERS and CalSTRS do not invest in companies whose products have the ability to cause significant social harm.

Con: Infringes upon the investment authority of the board.

Broad provisions may significantly reduce the investable universe.

The measure does not indemnify the board and staff from liability for losses.

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