BILL NUMBER: SB 185 (De León) as amended March 25, 2015

SUMMARY

SB 185 requires 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; prohibits additional or new investments or the renewal of existing investments in thermal coal companies; and requires an assessment of the feasibility of divesting from additional fossil fuel investments, such as natural gas and petroleum.

BOARD POSITION

No position, but recommend amendments to (a) remove the requirement that CalSTRS consult with the Secretary of the California Environmental Protection Agency (CalEPA) when assessing the feasibility of divesting from fossil fuels and (b) delete requirements that the board adopt findings supporting determinations that divestment would be inconsistent with its fiduciary responsibilities. Although the board's policy generally would be to oppose legislation that infringes on the investment authority of the board, at its April 2015 meeting, the Investment Committee initiated the board's divestment policy of due diligence, engagement and possible divestment with respect to the investments affected by the bill.

REASON FOR THE BILL

As stated by the findings and declarations of the bill, the combustion of thermal coal is the single largest contributor to climate change in the United States, and climate change affects all parts of the California economy and environment.

SUMMARY OF AMENDMENTS

Among other provisions, the March 25, 2015, amendments:

- Clarify the definition of “thermal coal company.”
- Require CalSTRS to engage with thermal coal companies to determine whether they are transitioning their business model to adapt to clean energy generation.
- Provide indemnification for board members for any liabilities that result from decisions that are made to carry out the legislation.

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, SB 185:

- Defines “thermal coal company” as a publicly traded company that generates 50 percent or more of its revenue from the mining of thermal coal, as determined by the board;
- Prohibits the board from making additional or new investments or renewing existing investments in a thermal coal company;
- Requires the board to liquidate investments in thermal coal companies within 18 months of enactment provided that doing so is consistent with its fiduciary responsibilities;
- Requires that in determining to liquidate investments, the board shall constructively engage with thermal coal companies in which it is invested to establish whether the company is transitioning its business model to adapt to clean energy generation, such as through a decrease in its reliance on thermal coal as a revenue source;
- Requires the board to report to the Legislature and the Governor on or before January 1, 2018, listing the thermal coal companies of which it has liquidated its investments, those companies with which the board has engaged and established were transitioning to clean energy generation with supporting documentation to substantiate the board’s determination, those thermal coal companies that the board has not divested because to do so would be inconsistent with its fiduciary responsibilities and any such findings adopted in support of such a determination;
- Requires the board to consult with the CalEPA Secretary to assess the feasibility and implications to the fund of divesting from additional fossil fuel investments, such as natural gas and petroleum, and requires that a summary of the assessment be included in the report to the Legislature and the Governor; and
- Indemnifies board members, state officers and employees, and investment managers from liabilities, losses and damages resulting from decisions to restrict, reduce or eliminate investments pursuant to this bill.

Amendments are recommended to remove the requirement that CalSTRS consult with the CalEPA Secretary when assessing the feasibility of divesting from fossil fuels. Any assessment must be consistent with the board’s fiduciary duty, and the board would consult with experts or consultants as it deems appropriate. Amendments are also recommended to remove the requirement that the board adopt findings supporting determinations that divestment would be inconsistent with its fiduciary responsibilities. Requiring such findings would be inconsistent with the board’s fiduciary responsibilities for which the process is paramount.

LEGISLATIVE HISTORY

AB 1410 (Nazarian, 2015) would seek to encourage the government of Turkey to acknowledge, and to reach resolution on reparations for survivors of, the Armenian

Genocide by requiring CalSTRS and CalPERS to divest of any investment vehicle issued by, owned, controlled or managed by the government of Turkey; would require these boards, on or before January 1, 2017, and annually thereafter, to report to the Legislature any investments in a Turkish investment vehicle and the sale or transfer of those investments, subject to the fiduciary duty of these boards; and would indemnify from the General Fund and hold harmless the present, former and future board members, officers and employees of and investment managers under contract with those retirement systems.

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, Statutes 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 1967 (Torrico, 2008) would have prohibited CalSTRS and CalPERS from investing in a private equity company that is owned by a sovereign wealth fund (SWF), or in a fund managed directly or indirectly by a private equity company that is owned by a SWF, if the countries associated with that SWF do not meet specified human rights criteria. This bill was held in the Assembly Public Employees, Retirement, and Social Security Committee.

SB 461 (Ashburn, 2007) would have prohibited CalSTRS and CalPERS from investing in a company with business operations in a foreign terrorist state, as specified, and would have required the boards to sell or transfer any investments in these companies and report to the Legislature regarding these investments. This bill was held in the Senate Public Employment and Retirement Committee.

AB 221 (Anderson, Chapter 671, Statutes 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.

AB 107 (Knox, 2000) would have prohibited new or additional investments in tobacco companies by CalSTRS and CalPERS on and after January 1, 2001, and would have required divestment from existing investments by July 1, 2002. This bill was held in the Assembly with concurrence pending.

AB 2251 (Margolin, Chapter 1351, Statutes of 1992) prohibited state trust funds from making new or additional investments in business firms or financial institutions that engage in discriminatory business practices after January 1, 1994, relating to the Arab League's economic boycott of Israel. The California Attorney General concluded that this bill was pre-empted by federal law and, therefore, not subject to implementation by CalSTRS.

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. Specified exemptions and granted board indemnification.

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 Environmental, Social and Governance Risks (ESG). 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 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.

Board-Directed Divestment
In addition to the enacted divestment legislation, on two separate occasions, the board has acted consistent with its own policies and fiduciary responsibilities to initiate divestment efforts of its own.

Tobacco—In June 2002, the board passed the CalSTRS Benchmark Modification Policy. The policy removed tobacco companies from the benchmarks of all CalSTRS managers and effectively divested of tobacco from passive managers. However, active managers could still purchase tobacco securities. In June 2009, the board revisited the tobacco issue and passed a resolution to divest of tobacco in all portfolios for violating the 21st risk factor–Human Health.

Firearms—In January 2013, following the Sandy Hook Elementary School tragedy in Connecticut, the Investment Committee directed staff to begin the divestment process with the two publicly traded U.S. companies within the CalSTRS portfolio that manufacture firearms and high-capacity magazines illegal for sale to, or possession by, the public in California, Sturm Ruger and Smith & Wesson. CalSTRS also holds a minority stake in Cerberus funds, but active efforts for Cerberus to sell gun manufacturer holding company Freedom Group are still pending.

Staff estimates that portfolio decisions affecting tobacco and illegal firearms have resulted in a net investment portfolio that is more than $4 billion less than it would have been if CalSTRS had remained in such investments.

Fossil Fuel Divestment
In an effort to tip the discussion around climate change, there is growing movement to compel pensions and universities to divest of fossil fuels. Over the last two years, legislation has been introduced in the District of Columbia, Maine, Massachusetts and Vermont to require the divestment of all fossil fuel companies from the assets of public retirement funds. At this point, not one of these bills has been passed. Similarly, in 2014, the University of California considered and decided against divesting of its investments in fossil fuels. Across the country, university endowments have been entering the divestment fray. While many have also decided against the wholesale divestment of fossil fuel investments, Stanford University recently voted on a narrower proposal to divest of all publicly traded companies whose principal business is the mining of coal for use in energy generation.

In contrast to previous divestment movements, in which divestment was proposed to eliminate “socially unacceptable” assets from the portfolio, those attempting to influence state legislatures, pension boards and university endowments to divest of fossil fuels are employing a unique economic argument–the fossil fuel reserves that companies routinely disclose in market valuations are in fact “stranded assets” because they will never be recoverable. As a result, the fuel divestment movement argues that divestment is prudent from an investment perspective because it is only a matter of time before the valuations catch up with the regulatory changes that must be realized if the world is to effectively confront climate change.

Consistent with its ESG policy, CalSTRS has long supported global action on climate change and has even increased investments in low-carbon solutions as renewable technology costs come down and regional clean energy policies take hold. In addition to the ESG policy, CalSTRS has also established an environmentally focused Green Initiative Task Force to highlight environmental-themed investments and environmental risk management. The stated mission of the task force is “to manage the risks and capture the opportunities associated with global sustainability issues by identifying environmentally focused strategies intended to enhance the risk-adjusted returns of the CalSTRS Investment Portfolio.” As part of assessing environmental risks, CalSTRS considers not only how a particular investment affects the environment but also how the environment affects a particular investment. CalSTRS examines how the supply of natural resources might be disrupted, for example, by drought, flood and mineral depletion. Similarly, CalSTRS examines the potential for demand disruption, as may be the case with increased regulation leading to the potential sequestration of fossil fuels.

Consistent with the board’s divestment policy and as a long-term investor committed to sustainability, CalSTRS prefers engagement as a means of managing these risks. If CalSTRS divests of a company and someone else buys that stock, CalSTRS no longer has a seat at the table and cannot effect change in that company. Engagement with market participants to improve environmental risk management has focused on a variety of issues, including energy efficiency, hydraulic fracturing, carbon emissions management and fossil fuel reserve valuations. While acknowledging that the magnitude of valuation losses that may occur as a result of increased fossil fuel regulation is difficult to predict, CalSTRS has begun a dialogue with several companies to determine whether they have considered various scenarios under which existing reserves could become sequestered or stranded. If the board determines that the potential of material loss is of such a degree that owning investments in a particular company would be inconsistent with its fiduciary responsibilities, the board will instruct staff to liquidate all such investments and find suitable alternatives with which to invest.

It would be optimal if decisions on whether to divest from particular investments were left to the board, utilizing its divestment policy. Accordingly, at its April 2015 meeting, the board’s Investment Committee initiated the divestment policy directing staff to evaluate the risk of investment in thermal coal companies using the policy and the 21 Risk Factors. The level of due diligence provided for by the divestment policy is designed to ensure that all the board’s fiduciary obligations are being met. By initiating the divestment policy, CalSTRS will follow the required process of due diligence and engagement ahead of the timeline outlined in the legislation.

FISCAL IMPACT

Program Cost – CalSTRS invests in 12 companies with a combined market value of approximately $40 million that meet the definition of “thermal coal company” set forth in the bill. 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.

Administrative Costs/Savings – Approximately $683,500 initial costs and $129,100 annual ongoing costs resulting from transaction costs for liquidating securities, benchmark modification costs and additional costs related to external research services. Implementation and ongoing compliance will also require reallocation of staff resources. Additional unknown costs will be required to assess the feasibility of divesting from additional fossil fuel investments, as required by the bill.

SUPPORT

None known.

OPPOSITION

None known.

ARGUMENTS

Pro: Could eliminate the perception that CalSTRS is contributing to climate change by investing in thermal coal companies.

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

May reduce the investable universe and adversely affect portfolio performance.

LEGISLATIVE STAFF CONTACT

John Maradik-Symkowick
Legislative Advocate,
CalSTRS Legislative Affairs,
(916) 414-1977
jmaradik-symkowick@calstrs.com

Mary Anne Ashley
Director,
CalSTRS Governmental Affairs and Program Analysis,
(916) 414-1981
mashley@calstrs.com

Nancy Farias
Deputy Secretary, Legislation,
California Government Operations Agency,
(916) 651-9373
nancy.farias@govops.ca.gov