

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Senate Concurrent Resolution 11 Senator Soto (As amended 4/24/03)

Position: Support, if Amended

Proponents: AIDS Care Foundation (Sponsor), CFT

Opponents: None known

SUMMARY

Senate Concurrent Resolution 11 encourages state and local public retirement systems to introduce shareholder resolutions instructing those companies to make HIV/AIDS drugs affordable to patients in less developed countries. The bill also makes findings regarding the effects of the HIV/AIDS pandemic in Africa and the insufficiency of pharmaceutical manufacturers' response.

HISTORY

ACR 55 (Migden—2001) urges CalSTRS and CalPERS to support shareholder resolutions instructing those companies to develop and implement a policy to provide HIV and AIDS drug treatments to less developed countries.

CURRENT PRACTICE

According to the Joint United Nations Programme on HIV/AIDS (UNAIDS), sub-Saharan Africa is the region most affected by HIV/AIDS, with approximately 29.4 million people infected by the disease, 10 million being between the ages of 15 and 24 and 3 million under age 15. Last year, approximately 3.5 million people became infected and 2.4 million people died from HIV/AIDS in the region.

As part of an on-going effort over the past few years to address the crisis in Africa, AIDS activists and human rights organizations have urged manufacturers of AIDS drugs to provide their products at little or no cost to those infected in less developed countries. The high cost of HIV/AIDS drugs is due in great part to manufacturers' considerable costs associated with research and development, complying with Food and Drug Administration standards, and paying licensing fees to research universities or other companies.

The brand-name companies earn little on the HIV/AIDS medicines in the less developed countries because so few people in these countries can afford the drugs. Ninety percent of the HIV/AIDS drugs sold last year were in five countries: the United States, France, Italy, Germany and Britain. The brand-name companies have reduced their prices in less developed countries,

which they claim has amounted to about a \$2 billion subsidy. However, the major drug companies have not been able to match the prices of copycat AIDS drugs produced by manufacturers based in countries such as Brazil, India, South Korea, China and Argentina, which are not only making copycat versions of patented AIDS medicines, but also copycat medicines to treat cancer, high cholesterol and other diseases. For example, GlaxoSmithKline sells the AIDS drug Combivir for about \$7,000 a year in the United States, while Cipla Ltd., a manufacturer in India, is offering its copycat version of Combivir for \$275.

In June 2002, the World Trade Organization (WTO) relaxed its position on the Trade Related Aspects of Intellectual Property Rights by extending a waiver releasing least developed countries from having to provide patent protection for pharmaceuticals until 2016. WTO member governments also failed to meet the year-end deadlines in 2002 for agreement in negotiations on "special and differential treatment" for developing countries and on access to essential medicines for poor countries lacking capacity to manufacture such drugs themselves. As holders of these patents, the major drug companies are concerned that patent protection for their HIV/AIDS drug treatments continue to be in jeopardy.

Dissatisfied with the responses of the major manufacturers of HIV/AIDS treatments, religious investors and socially responsible investing groups introduced, and later withdrew the first shareholder resolution on this issue after an agreement with Pfizer in 2001. In 2002, these groups introduced resolutions asking nine companies to provide affordable pharmaceuticals to combat AIDS, tuberculosis (TB) and malaria in Africa. Most shareholder proposals are not binding and simply request the company to make a change. Shareholder proposals and resolutions which asks or urges the board to adopt and implement a policy are submitted to the company by a shareholder under rule 14(a-8) of the Securities and Exchange Commission.

Most of the companies challenged the proposal on grounds that the language contained in the proposal violated Securities and Exchange Commission (SEC) rules that prohibit resolutions dealing with "ordinary business issues." The proposal came to a vote only at Abbott Labs, with CalSTRS in support, and was withdrawn at the other companies before the SEC staff made any ruling on the legitimacy of the proposal. Proponents characterized last year's efforts as exploratory, allowing them to conduct research and gain helpful information from their meetings with companies. This year, proponents introduced a revised proposal at these same companies. Individual investors, however, have begun to introduce resolutions of their own. For example, at Merck an individual shareholder proposed a similar resolution asking the company to outline "additional steps the pharmaceutical industry can take to help address the AIDS pandemic," including resolving cross-licensing issues "to accelerate the production of a simplified single pill antiretroviral regimen suitable for the developing world." The shareholder withdrew his proposal after the company petitioned the SEC staff for permission to omit it as duplicative of the Interfaith Center proposal filed by the Unitarian Universalist Service Committee.

This year proponents also introduced shareholder resolutions urging pharmaceutical companies to "establish and implement standards of response to the health pandemic of HIV/AIDS, TB and malaria in developing countries, particularly Africa." Investors affiliated with the Interfaith Center proposed this to Bristol-Myers Squibb, Johnson & Johnson, Eli Lilly, Merck, Pfizer and Wyeth (all have since been withdrawn), and are also consulting with Abbott Labs, Glaxo SmithKline, Novartis and Roche on the issue.

According to CalSTRS investment staff, religious investors and socially responsible investing groups have recently promoted shareholder resolutions at companies that do not manufacture drugs, but rather are major employers in sub-Saharan Africa. An entirely new approach to the issue, it asks companies with substantial leverage in the region's labor to report on the effect of deadly diseases on their operations as well as on any measures they have taken in response. Interfaith Center members introduced this resolution to U.S.-based multinationals Caterpillar (withdrawn), Chevron Texaco, Exxon Mobil, Ford Motor and PepsiCo; and they continue to communicate with Coca-Cola, Dow Chemical, General Motors, Goodyear and Royal Dutch Petroleum on the issue. Caterpillar challenged the resolution unsuccessfully at the SEC under exclusion (i)(5) of the shareholder proposal rule, which allows companies to omit proposals that aren't relevant to their business—an exclusion that is rarely granted.

DISCUSSION

Specifically, Senate Concurrent Resolution 11:

“...encourages the governing bodies of the public pension and retirement systems of this state, in their capacities as shareholders of pharmaceutical companies that develop HIV and AIDS drug treatments, to introduce, whenever consistent with their fiduciary responsibilities, a shareholder resolution to develop and implement a policy, in consultation with the appropriate United Nations agencies and independent nongovernmental organizations, to provide HIV and AIDS drug treatments in a manner that would make those treatments affordable to the majority of those infected with HIV and AIDS in lesser developed countries”

SCR 11 does not propose the divestment of stocks owned by the System, nor does it limit or restrict the corporations or types of stocks that may be held by the System.

According to the Senate Public Employment and Retirement Committee: “AIDS activists are concerned that the cost of AIDS drugs makes those drugs unavailable to AIDS infected people living in the third world, specifically on the continent of Africa. AIDS activists are seeking lower drug prices through corporate governance actions by institutional investors such as the public pension funds of California.”

The fiduciary standards in the Teachers' Retirement Law (TRL) and Article XVI, Section 17 of the state Constitution require the Board, CalSTRS officers and employees to discharge their duties with respect to the System 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. 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 Board does recognize, however, a responsibility not only to CalSTRS members and beneficiaries, but to the general public as well. It is Board policy to vote in favor of shareholder resolutions, which if implemented, prevent, reduce or eliminate social injury. Corporate practices regarding equal access to basic services such as medical care is one of many non-economic factors the Board considers when voting shareholder proxies.

Developing a policy to provide HIV/AIDS treatments that are affordable to a majority of those infected in less developed countries may be impossible for shareholders or the drug companies to implement, since it involves more than just getting HIV/AIDS drugs into the countries. First, the number of people infected must be determined in order to know whether a majority are able to afford the drugs. It may be the case that these treatments are not affordable to a majority of those infected at any price. As part of its fiduciary duty, a public retirement system board should consider the financial impacts of the ongoing patent issues and the concerns stated above, before taking an action that might place the affected companies at a competitive disadvantage.

In many instances, individual governments in the region may offer the best hope since they, in consultation with NGOs, are able to assess the impact of the pandemic on their citizens, and manufacture and/or distribute treatments. For example, Brazil buys the active ingredients for AIDS drugs in bulk and then makes them into pill form in government-run factories and provides them free to its citizens. This would remove the burden from shareholders and prevent affected companies from placing themselves at a competitive disadvantage to the copycats and other brand-name manufacturers.

CalSTRS' investment staff has reviewed resolutions submitted to a number of drug companies asking that policies be created to implement price restraints on pharmaceutical products. A majority of these resolutions faced technical challenges based on SEC rules and/or were withdrawn by the shareholders that introduced them. The one resolution that staff was able to document made it to a vote was at Abbot Labs, and that resolution failed by a wide margin. The System does not currently maintain a list or independently monitor its investments in pharmaceutical companies that manufacture HIV/AIDS treatments. As socially responsible investors continue to expand their efforts in this area, staff anticipates more resolutions will be proposed that will, in many cases, be duplicative and ultimately disallowed under SEC rules. Since CalSTRS introduces only a limited number of shareholder resolutions each year, staff is concerned with the amount of time and resources needed to introduce resolutions on this subject when considering their possible failure for various technical reasons.

In the instance of the international drug companies, a resolution must be certified as supported by the holders of at least 10 percent of the outstanding shares before it can be put on the ballot. The proposing shareholder must have a legal representative travel to the meeting. In CalSTRS' case, international proxies are delegated to the outside investment managers. The System may be able to use them as its legal representative to reduce travel costs for staff. In addition, the System must retain lawyers in the company's home country to draft each proposal according to local

market laws and assist with any language translation that may be necessary. Staff notes there are several corporate governance professionals in Europe with experience introducing shareholder resolutions.

FISCAL IMPACT

Program Costs– None

Administrative Costs– CalSTRS investment staff has not established a list that identifies individual segments of the drug industry, such as those companies that manufacture HIV/AIDS treatments. Staff estimates costs to commission such a list from an outside vendor would be approximately \$25,000. If SCR 11 in its current form is implemented, CalSTRS' resources would be directed towards staff time garnering shareholder support, legal representation, proxy solicitation costs and travel. These expenses associated with sponsoring shareholder resolutions are large, costing upwards of \$250,000 or more.

BOARD POSITION

Support, if amended to urge support of shareholder resolutions. Because introducing shareholder resolutions will result in substantial direct economic costs to CalSTRS, staff recommends the Board support SCR 11 if it is amended to encourage public retirement systems to instead support such shareholder resolutions whenever feasible and consistent with their fiduciary responsibilities.

Support of shareholder resolutions that encourage companies to prevent social injury is consistent with the Board's current governance policy.