Investment Committee

California Public Employees' Retirement System

Agenda Item 6a

April 15, 2013

ITEM NAME: AB 761 (Dickinson) – Firearm and Ammunition Manufacturer Divestment

As Amended March 19, 2013

Sponsor: Author

PROGRAM: Total Fund

ITEM TYPE: Legislation – Action

RECOMMENDATION

Adopt an **Oppose** position, as this bill would place a restriction on the Board of Administration's (Board) investment authority.

EXECUTIVE SUMMARY

AB 761 (Dickinson) would prohibit the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) from investing in any company with business operations described as the "manufacture of firearms or ammunition for any recipient other than the United States military" (SEC 7513.4 (a)), requiring the systems to sell or transfer any investments in a company with these business operations, and report to the Legislature on an annual basis any investments in a company with these business operations and the sale or transfer of those investments.

Divestment legislation presents unique challenges because of the many issues and interests involved. For the reasons set forth in more detail below, CalPERS legislative policy suggests an oppose position on proposals that impose any investment mandate or restriction on the Board's investment authority. In addition, once CalPERS divests from any particular company, it loses the opportunity to constructively engage the company to effectuate positive change.

STRATEGIC PLAN

This item is not a specific product of the CalPERS Strategic Plan, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

BACKGROUND

1. Constitutional Authority and Fiduciary Responsibility
   Article XVI, Section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement board of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the "exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system." The Constitution also requires the boards of public pension funds to "diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so."

   The Constitution, however, provides 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 that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

   In accordance to the California Constitution Article XVI, Section 17, the Board's constitutional duties take precedence over any other considerations. Other considerations will be entertained only when not in conflict with any of these duties.

2. CalPERS Policy Regarding Divestment
   CalPERS Statement of Investment Policy Regarding Divestment, states "CalPERS investment in a company does not necessarily signify that it approves of the company's policies, products, or actions…CalPERS prefers constructive engagement to Divesting as a means of affecting the conduct of entities in which it invests."

3. Recent Board Action to Divest from Assault Weapon Manufacturers
   Following the December 2012 tragedy in Newtown, Connecticut, CalPERS Board Member, Bill Lockyer, California State Treasurer, requested CalPERS conduct a review of its exposure to firearms manufacturers that produce, and distribute to the general public, weapons illegal for public sale under California Firearms Laws 2007.

   Staff reviewed CalPERS investment portfolio and conducted a fiduciary analysis in a manner consistent with CalPERS Statement of Investment Policy Regarding Divestment. Staff identified approximately $5 million of exposure to two firearms manufacturers. The exposure was contained in programs that transact in publicly traded equity securities and divestment was considered "de minimis."

The Board, following review of staff's fiduciary analysis and in accordance with the CalPERS divestment policy, approved the divestiture of direct investments in the two identified companies.

ANALYSIS

1. Assembly Bill No. 761

   Assembly Bill No. 761 (AB 761) (Attachment 1) prohibits CalPERS and CalSTRS from investing public employee retirement funds in companies with business operations that are described as the "manufacturing of firearms or ammunition for a recipient other than the United States military" (SEC 7513.4 (a)). AB 761 requires the following:

   a. The Board to review its investment portfolio on an annual basis to identify which companies may be subject to divestment (SEC 7513.4 (c)).

   b. Notify any company "manufacturing firearms or ammunition for a recipient other than the United States military" (SEC. 2 7513.4 (a)) and request the company take "substantial action" defined as "selling assets, equipment, or real and personal property of a company that manufactures, sells, markets, or distributes firearms or ammunition" (SEC. 2 7513.4 (a)). If, based on publicly available information, a company has taken "substantial action" or has made progress to this effect the company will not be subject to further action (SEC 2. Section 7513.4 (e)).

   c. Monitor and review the progress of each company no later than every 90 days (SEC 2. Section 7513.4 (e)).

   d. Determination of "substantial action" by companies be supported by evidence and followed by a "roll-call vote of the Board" (SEC 2. Section 7513.4 (e)).

   e. If a company fails to take "substantial action" the Board shall not make any new investments in the company and liquidate any investments in the company within 18 months consistent with the Board's fiduciary duty (SEC 2. Section 7513.4 (f)).

   f. Contact, in writing, fund managers requesting the removal of companies which fail to take "substantial action" held via externally and actively managed commingled funds (SEC 2. Section 7513.4 (d)).

g. If the Board determines that divestment from a company that fails to take “substantial action” would be inconsistent with its fiduciary duty, as outlined in Section 17 Article XVI of the California Constitution, the Board “shall demonstrate how divestment disadvantages the fund and that any feasible investment alternatives would yield a lower rate of return with commensurate degrees of risk, or create a higher degree of risk with commensurate rates of return” (SEC 2. Section 7513.4 (h)). Determination requires a roll-call vote in open session.

h. Report to the Legislature any investments, or sale or transfer of investments, that “manufacture firearms or ammunition for a recipient other than the United States military” (SEC. 2 7513.4 (a)), subject to the Board’s fiduciary duty by January 1, 2015 (SEC 7513.4 (g)). According to SEC 7513.4, the report shall include:
    i. A list of investments the Board has in companies with the specified business operations, including, but not limited to, the issuer, by name, of the stock, bonds, securities, and other evidence of indebtedness.
    ii. A detailed summary of the business operations of each company identified.
    iii. Whether the board has reduced its investments in each company.
    iv. If the board has not completely reduced its investments in a given company, a timeline for when the board anticipates that it will reduce all investments in that company or adopt the findings in support of a determination as to why a sale or transfer of investments is inconsistent with the board’s fiduciary responsibilities.
    v. A detailed summary of investments that were transferred to funds or accounts devoid of the specified companies.
    vi. An annual calculation of any costs or investment losses or other financial results incurred in compliance with this section.
    vii. Findings and any public comments regarding the adopted findings and determinations made by the Board in its open session discussion.

2. <u>Divestment Law in California</u>
Over the past 30 years, California has enacted three major divestment statutes, all targeting nations that were commonly acknowledged to have violated human rights or posed threats to national security: South Africa, Sudan, and Iran. Additional legislative history is provided as Attachment 2. The goal of each legislative act was to impact the actions of targeted regimes that depended on the revenue, products or services of companies in which CalPERS invested, primarily by pressuring companies to terminate any business activities that benefitted the target.

The individual companies typically responded based on their analysis of the financial benefits of maintaining business ties to the targeted country versus the financial risks of losing investment. In these situations, a company may have also considered the potential for its targeted business operations becoming threatened by Federal or international sanctions, which were eventually imposed in all three of the above-mentioned cases.

This proposed bill on firearms would set a troubling precedent by requiring divestment from companies that manufacture legal products under State and Federal law that are not the target of Federal or international sanctions. CalPERS existing policy on divestment addresses situations where there may be concern over a company's activities with an emphasis on engagement. In accordance to the California Constitution Article XVI, Section 17, the Board's constitutional duties take precedence over any other considerations.

FISCAL IMPACT

1. <u>Benefit Program Costs</u>
   The Board is obliged to invest pension assets for the exclusive purpose of paying benefits to the plan participants. Limiting investment opportunities or reducing diversification results in lower than expected investment returns which leads to higher employer contribution rates.

   <u>Cost of Transitioning the Securities for Divestment into Other Securities</u>
   This cost will depend on CalPERS holdings in the companies identified by staff through publicly available information and the criteria for divestment in the enacted version of AB 761.

   The legislative proposal does not define "firearms" or "ammunition" and no definitive list of companies manufacturing these items exists. The proposal specifies that the only excluded firms are those that manufacture exclusively for the U.S. Government.

2. <u>Administrative Cost</u>
   Staff estimate that implementation of AB 761 would cost approximately $770,000 in administrative expenses over a two-year period. This amount is based on staff's cost estimate for Assembly Bill 1151 (Iran) and includes staff time required to research, validate, and engage approximately 8 companies, and report to the Board and the Legislature. This legislative proposal will continue to have an annual administrative expense, as long as CalPERS is required to report.

BENEFITS/RISKS

Should this bill pass, the CalPERS Investment Office would need to divert resources away from making and managing investments toward analyzing and reporting on its holdings and divestment actions. Moreover, legislation was enacted in 2010 that states any new annual reporting requirement should cease after five years, and this bill requires reporting in perpetuity as does reporting on Sudan, Iran, and Holocaust Era and Northern Ireland.

ATTACHMENTS

Attachment 1 – AB 761
Attachment 2 – Legislative History

DANNY BROWN, Chief
Office of Governmental Affairs

JOSEPH A. DEAR
Chief Investment Officer

AMENDED IN ASSEMBLY MARCH 19, 2013

CALIFORNIA LEGISLATURE—2013–14 REGULAR SESSION

ASSEMBLY BILL No. 761

Introduced by Assembly Member Dickinson

February 21, 2013

An act to add Section 7513.4 to the Government Code, relating to public retirement systems.

LEGISLATIVE COUNSEL'S DIGEST

AB 761, as amended, Dickinson. Public retirement systems: investments.

The California Constitution provides that the Legislature may by statute prohibit retirement board investments if it is in the public interest to do so, and providing that the prohibition satisfies specified fiduciary standards.

Existing law prohibits the boards of the Public Employees' Retirement System and the State Teachers' Retirement System from investing public employee retirement funds in a company with active business operations in Sudan and Iran, as specified.

This bill would additionally prohibit the Public Employees' Retirement System and the California State Teachers' Retirement System from investing public employee retirement funds in a company with business operations that are described as the ~~manufacture, sale, marketing, or distribution~~ *manufacture* of firearms or ammunition, as specified. The bill would require the Board of Administration of the Public Employees' Retirement System and the Teachers' Retirement Board of the State Teachers' Retirement System to sell or transfer any investments in a company with these business operations.

This bill would require these boards to report to the Legislature any investments in a company with these business operations and the sale or transfer of those investments, subject to the fiduciary duty of these boards, by January 1, 2015, and every year thereafter.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

SECTION 1. The Legislature finds and declares all of the following:

(a) According to the Office of the Attorney General, approximately 2,900 persons were hospitalized in 2011 due to injuries from a firearm, and approximately 2,800 persons were killed by firearms either by homicide, suicide, or accident.

(b) Statistics compiled by the Federal Bureau of Investigation (FBI) demonstrate that firearms are overwhelmingly the most common weapon used in California homicides.

(c) According to the FBI, while California ranks 30th in gun deaths per capita, California had the highest number of total gun deaths out of any state last year, accounting for 68 percent of all gun murders in the United States.

(d) Approximately 600,000 guns are sold by dealers every year in California, a sharp increase over time compared to 200,000 per year in 2002.

(e) Comprehensive surveys of gun violence from 2011 have shown that firearms play a major role in violent crime in California.

(f) Notwithstanding the fact that California has made significant strides to reduce gun violence, guns continue to be a major threat to public health and safety.

(g) Numerous gun violence prevention groups, including The Brady Campaign to End Gun Violence and The Law Center to Prevent Gun Violence have praised California's record of developing innovative solutions to gun violence which serve as models for other states and for the federal government.

(h) The Legislature therefore finds that the divestment of public employee retirement funds from companies that ~~manufacture, sell, market, or distribute~~ *manufacture* guns and ammunition *for a recipient other than the United States military* is in the public interest of the state, for the preservation of the public peace, health, or safety.

SEC. 2. Section 7513.4 is added to the Government Code, to read:

7513.4. (a) As used in this section, the following definitions shall apply:

(1) "Board" means the Board of Administration of the Public Employees' Retirement System or the Teachers' Retirement Board of the State Teachers' Retirement System, as applicable.

(2) "Business operations" means ~~manufacturing, selling, marketing, or distributing~~ *manufacturing* firearms or ammunition *for a recipient other than the United States military*.

(3) "Company" means a sole proprietorship, organization, association, corporation, partnership, venture, or other entity, its subsidiary or affiliate that exists for profitmaking purposes or to otherwise secure economic advantage.

(4) "Invest" or "investment" means the purchase, ownership, or control of stock of a company, association, or corporation or corporate bonds issued by a company which manufactures, sells, markets, or distributes firearms or ammunition.

(5) "Public employee retirement funds" means the Public Employees' Retirement Fund described in Section 20062, and the Teachers' Retirement Fund described in Section 22167 of the Education Code.

(6) "Substantial action" means selling assets, equipment, or real and personal property of a company that manufactures, sells, markets, or distributes firearms or ammunition.

(b) The board shall not invest public employee retirement funds in a company that has business operations as described in paragraph (2) of subdivision (a) as identified by the board through any source of public information, as the board deems appropriate, including, but not limited to, information provided by nonprofit and other organizations and government entities.

(c) Annually, on or before June 30, the board shall review its investment portfolio and determine which companies are subject to divestment.

(d) (1) If the board's investment in a company described in subdivision (b) is limited to an investment via an externally and actively managed commingled fund, the board shall contact that fund manager in writing and request that the fund manager remove that company from the fund as described in subdivision (f). On or before June 30, if the fund or account manager creates a fund or account devoid of companies described in subdivision (b), the transfer of board investments from the prior fund or account to the fund or account devoid of companies with business operations as described in paragraph (2) of subdivision (a) shall be deemed to satisfy subdivision (f).

(2) If the board's investment in a company described in subdivision (b) is limited to an alternative fund or account, the alternative fund or account manager creates an actively managed commingled fund that excludes companies described in subdivision (b), and the new fund or account is deemed to be financially equivalent to the existing fund or account, the transfer of board investments from the existing fund or account to the new fund or account shall be deemed to satisfy subdivision (f). If the board determines that the new fund or account is not financially equivalent to the existing fund, the board shall include the reasons for that determination in the report described in subdivision (g).

(3) The board shall make a good faith effort to identify any private equity investments that involve companies described in subdivision (b). If the board determines that a private equity investment clearly involves a company described in subdivision (b), the board shall consider, at its discretion, if those private equity investments shall be subject to subdivision (f). If the board determines that a private equity investment clearly involves a company described in subdivision (b), and the board does not take action as described in subdivision (f), the board shall include the reasons for its decision in the report described in subdivision (g).

(e) The board, in the board's capacity of shareholder or investor, shall notify any company described in subdivision (d) that the company is subject to subdivision (f) and permit that company to respond to the board. The board shall request that the company take substantial action no later than 90 days from the date the board notified the company pursuant to this subdivision. If the board determines based on credible information available to the public that a company has taken substantial action or has made sufficient progress toward substantial action before the expiration of that 90-day period, that company shall not be subject to an action described in subdivision (f). The board shall, at intervals not to exceed 90 days, continue to monitor and review the progress of the company until that company has taken substantial action. Any determination made at each 90-day interval that a company has taken substantial action shall be supported by findings adopted by a roll-call vote of the board following a presentation and discussion of the findings in open session, during a properly noticed public hearing of the full board. All proposed findings of the board shall be made public 72 hours before they are considered by the board, and the board shall maintain a list of interested parties who shall be notified of the proposed findings 72 hours before the board's consideration. The findings and any public comments regarding the adopted findings and determinations made pursuant to this subdivision shall be included in the report to the Legislature required by subdivision (g). A company that fails to complete substantial action within one year from the date of the initial notice by the board shall be subject to the actions described in subdivision (f).

(f) If a company described in subdivision (d) fails to complete substantial action by the time described in subdivision (e), the board shall take the following actions:

(1) The board shall not make additional or new investments or renew existing investments in that company.

(2) The board shall liquidate the investments of the board in that company no later than 18 months after this subdivision applies to that company. The board shall liquidate those investments in a manner consistent with the board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution.

(g) On or before January 1, 2015, and every year thereafter, the board shall file a report with the Legislature. The report shall describe the following:

(1) A list of investments the board has in companies with business operations that satisfy the criteria in subdivision (b), including, but not limited to, the issuer, by name, of the stock, bonds, securities, and other evidence of indebtedness.

(2) A detailed summary of the business operations of each company identified in paragraph (1).

(3) Whether the board has reduced its investments in a company with business operations that satisfy the criteria in subdivision (b).

(4) If the board has not completely reduced its investments in a company with business operations that satisfy the criteria in

subdivision (b), a timeline for when the board anticipates that the board will reduce all investments in that company or adopt the findings in support of a determination made pursuant to subdivision (h) pertaining to why a sale or transfer of investments is inconsistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution.

(5) A detailed summary of investments that were transferred to funds or accounts devoid of companies with business operations as described in subdivision (b).

(6) An annual calculation of any costs or investment losses or other financial results incurred in compliance with this section.

(h) Nothing in this section shall require the board to take action as described in this section if the board determines, and adopts findings, in good faith and based on credible information available to the public, that the action described in this section would fail to satisfy the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution. Any adopted findings shall demonstrate how divestment disadvantages the fund and that any feasible investment alternatives would yield a lower rate of return with commensurate degrees of risk, or create a higher degree of risk with commensurate rates of return. Notwithstanding any other law, any determination that an action would fail to satisfy the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution shall require a recorded roll-call vote of the full board, following a presentation and discussion of the findings in open session, during a properly noticed public hearing of the full board. All proposed findings of the board shall be made public 72 hours before they are considered by the board, and the board shall maintain a list of interested parties who shall be notified of the proposed findings 72 hours before board consideration. The findings and any public comments regarding the adopted findings and determinations made pursuant to this subdivision shall be included in the report to the Legislature required by subdivision (g).

(i) The report shall be submitted in compliance with Section 9795.

O

2009 AB 2337 (Ammiano) – Would have required all state and local public retirement systems in California to adopt a policy that restricts real estate investments in companies that engage in predatory investment practices that result in excessive rent increases imposed upon, or the eviction or displacement of, persons residing in rent-regulated housing in order to generate profits, as specified. Failed Passage. *CalPERS Position: Neutral*

2008 Chapter 671 (AB 221, Feuer) – Prohibits CalPERS and CalSTRS from investing public employee retirement funds, as defined, in a company with business operations in Iran that meets the following criteria: is invested in, or is engaged in, business operations with entities in the defense or nuclear sectors of Iran, or invested or engaged in the development of petroleum or natural gas resources of Iran and that company is subject to sanctions by the Federal Government; or in a company engaged in business operations with an Iranian organization that has been labeled a terrorist organization by the US Government. It also requires each Board to sell or transfer any investments in these companies within specific timeframes, and report to the Legislature regarding these investments. *CalPERS Position: Oppose*

2006 Chapter 442 (AB 2941, Koretz) – Prohibits CalPERS and CalSTRS from investing in a company with active business operations in Sudan, as specified. It also requires each Board to sell or transfer any investments in these companies within specified timeframes, and report to the Legislature regarding these investments. *CalPERS Position: Neutral, with suggested amendments.*

2003 Resolution Chapter 111 (SCR 11, Soto) – Encourages the state's public retirement systems, in their capacities as shareholders of pharmaceutical companies that develop human immunodeficiency virus (HIV) and AIDS drug treatments, to take affirmative action, whenever consistent with their fiduciary responsibilities to impel pharmaceutical companies, in consultation with the appropriate United Nations agencies and independent non-governmental organizations, to provide HIV and AIDS treatment in a manner that would make those treatments affordable to the majority of those infected with HIV and AIDS in lesser developed countries. *CalPERS Position: Support*

2000 AB 107 (Knox) – Would have prohibited CalPERS and CalSTRS from making any new or additional investments in tobacco companies beginning January 1, 2001 and the divestment of existing investments by July 1, 2002. Failed Passage. *CalPERS Position: Oppose*

1998 AB 1679 (Perata) – Would have prohibited state trust fund and state money from being invested in tobacco companies. Failed Passage. *CalPERS Position: Oppose*

AB 1744 (Knox) – Would have prohibited CalPERS and CalSTRS from making new or additional investments in any tobacco company on or after January 1, 1999. It also would have required a phased divestment beginning January 1, 2000 and continuing until January 1, 2002. Failed Passage. *CalPERS Position: Oppose*

SB 1433 (Hayden) – Would have prohibited CalPERS and CalSTRS from making new or additional investments in tobacco companies. Failed Passage. *CalPERS Position: Oppose*

AB 2357 (Olberg) – Would have prohibited public retirement funds from making new investments in any business firm that writes, records, or produces any song or musical work with lyrics that promote specified criminal acts. Furthermore, it would have required a phased divestment existing holdings. Failed Passage. *CalPERS Position: Oppose*