CalPERS

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. Benefit Program Costs
   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.

   Cost of Transitioning the Securities for Divestment into Other Securities
   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. Administrative Cost
   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

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